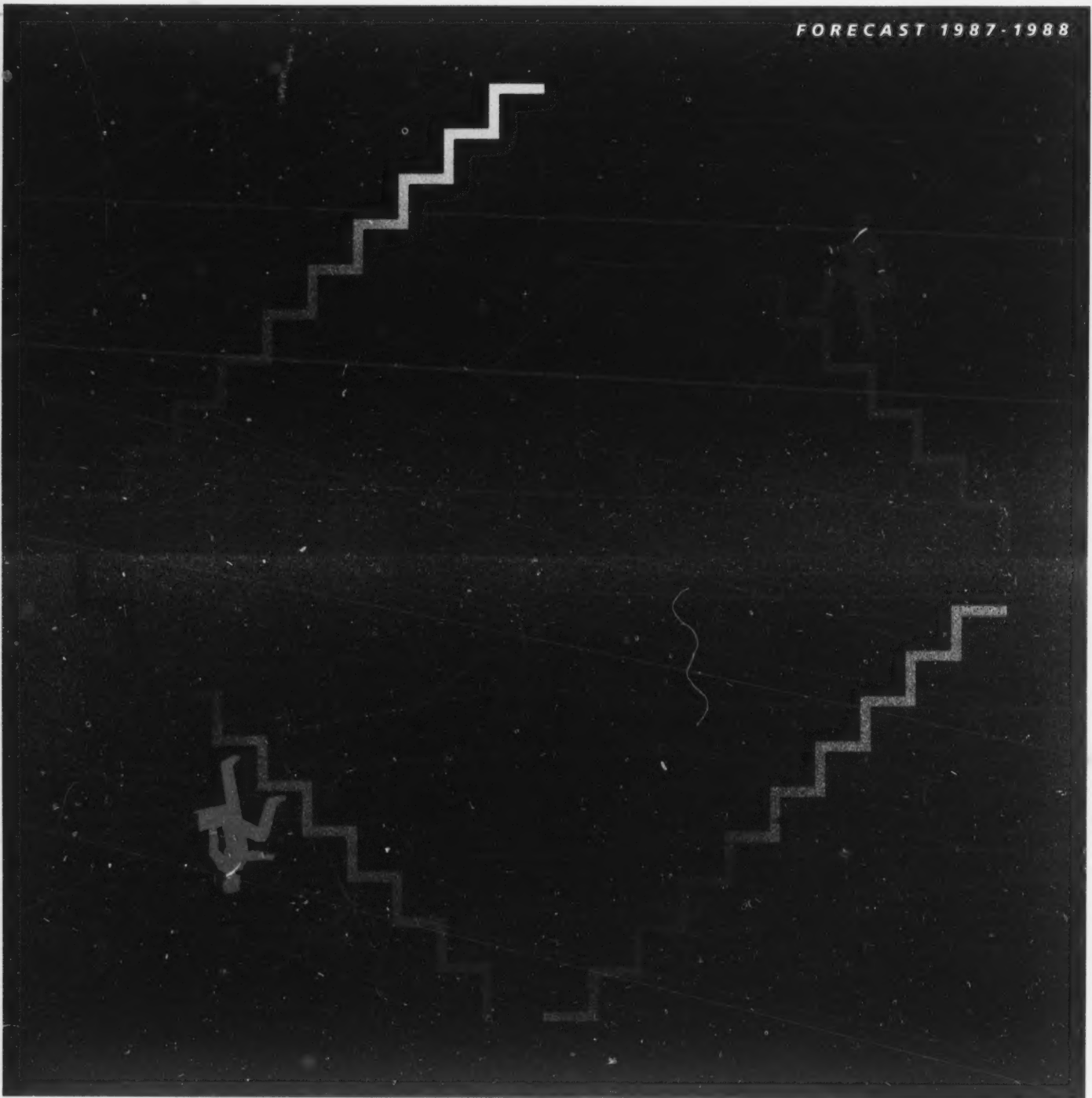


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FORECAST 1987-1988



First
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Note on Abbreviations

Abbreviations used in the charts in this publication include the following.

e: estimate
f: forecast

ASSUMPTIONS AND CONCLUSIONS



Recent economic performance, both in the United States and abroad, has been characterized by wide disparities that have colored the perceptions of businesses, politicians, and analysts. Thus, while overall U.S. economic growth recently has been

middling, various regions and industries have experienced depressed conditions, and others have boomed. Likewise, certain countries are now coping with serious external imbalances, while others face a very favorable environment. This year, First Interstate's Forecast analyzes these disparities, seeking to illuminate why there are such wide differences among observers of the economy. We expect the disparities to lessen over the next two years, but certain structural imbalances will remain.

Expansive Policies to Continue

U.S. economic policymakers started shifting to a "pro-growth" stance in early 1985 and are now openly committed to achieving faster growth of output and employment worldwide, without overriding concern about possible future inflation. Federal Reserve policy has become highly stimulative during the course of 1986, and we expect it to continue to be expansionary through 1987 and most of 1988.

The enormous size of the federal budget deficit has precluded activist fiscal policies in the recent past, but the 1986 tax reform legislation will create more latitude for new tax incentives designed to stimulate regions, sectors, or industries that are most depressed. The exact form of new fiscal initiatives cannot be known, but the desire of policymakers to promote higher incomes, output, and employment is unmistakable. Our forecast is based on the assumption that federal fiscal and monetary authorities will continue to provide stimulus until they are satisfied with the results.

Sustained Prosperity

The fifth year of uninterrupted economic growth will occur in 1987. The current expansion promises to be at least the second longest in the post-World War II period, exceeded only by the nine-year period of sustained growth in the 1960s.

Economic depressants, such as a strong U.S. dollar, high real interest rates, and falling world oil and other commodity prices, caused the economy's growth rate to be below potential from mid 1984 to mid 1986. However, the pace of expansion accelerated as the second half of 1986 got under way, and 1987 promises to be a year of more rapid growth. Although an economic boom is not likely, a recession is even less likely. Almost 6 million more people will be added to payrolls in the next two years, and personal income will rise faster than in 1985 and 1986.

The sub-par performance of the U.S. economy starting in the summer of 1984 can be traced to several economic depressants, but lack of consumer demand was not one of them. Real final domestic sales rose at an annual rate of nearly 4% from the second quarter of 1984 to the second quarter of 1986. The slower 2.5% growth of real GNP

was the result of the large and rapidly growing U.S. trade deficit and a much smaller addition to inventories.

Our expectation is that final demand will continue to grow at a healthy pace in 1987, and domestic output will grow more rapidly. A smaller share of the demand will be reflected in imported goods in the future, given the decline of the U.S. dollar on foreign exchange markets. Moreover, foreign demand for U.S.-produced goods is now rising, and will continue to do so in the year ahead. Business inventories will rise again next year, in part because they are very lean and also because interest rates have fallen substantially since the summer of 1984. We also are optimistic that there will be somewhat of a turnaround of capital spending in 1987.

Recovery Abroad

Several important foreign economies began to grow more rapidly in 1986 and are expected to experience solid growth next year. In some instances, the first substantial growth of output and employment in the 1980s is now occurring. Most European economies are improving, and some of the developing countries, such as Brazil, South Korea, and Taiwan, are enjoying an economic boom. Total world trade will expand more rapidly next year, and the U.S. external deficits will begin to shrink by 1988.

The generally favorable international environment will help those developing countries that export manufactures, but those dependent on commodities continue to face problems. The difficulties faced by commodity-exporting debtor countries are likely to result in new approaches to resolving the international debt crisis.

Shrinking Disparity

During the past four years of national economic expansion, some regions and some industries continued to contract, while others verged on boom conditions. Generally, the states in the East and in the Southwest performed well, while the Rocky Mountain and Midwest states were stagnant or contracting. The resulting "bicoastal economy" meant that economic data for the nation did not accurately reflect the conditions of most of the country. Just about every local economy was doing either much

better or much worse than the national-average statistics.

We expect this disparity to diminish somewhat over the course of 1987. A few of the recent outstanding performers, such as Arizona and Nevada, will grow more slowly. Meanwhile, some of the most depressed regions of the nation will begin to grow again. Even the states that suffered falling employment in the past year or two will stop contracting in 1987.

Some industries in the United States, such as mining, construction, and agriculture, will continue to be depressed and suffer declining employment. Total employment, however, will continue to rise, and the share of the adult population that is employed will continue to set record levels. The gains in employment will be greatest in trade and services, with especially strong increases in the financial and health-service industries. Communications, aerospace, and publishing industries will also prosper.

Both the automobile and housing industries peaked in 1986 and will experience lower output levels in the next two years. Nonresidential construction will also decline as office building, shopping center, and hotel construction slow. In contrast, manufacturing employment will finally shake out of the doldrums and start to account for a rising share of the employment gains. The transportation industries will also advance, as both domestic and international trade volumes expand and passenger traffic continues to increase.

Lowering Financial Market Barriers

As more states draft and approve interstate banking legislation, the pressure to do the same in the remaining states increases. It appears probable that most new legislation will be regional in nature and contain phase-in provisions designating a year in which states will open fully for nationwide banking. No omnibus federal legislation on the issue is expected to be approved during our 1987-88 forecast horizon. Financial globalization through even greater improvements in communication and technology will continue to open new markets to both savers and investors. Continuation of securitization also will tend to encourage new debt by making obligations marketable.



THE U.S. ECONOMY

The U.S. economy is forecast to grow at a faster pace in 1987 and 1988, and the disparity among different sectors should diminish. We expect real GNP to expand by 3.6% in 1987 and 3.4% in 1988, up from a 2.7% increase in 1986. During the next two years, different

regions, sectors and industries should grow at more similar rates, especially as manufacturing begins to benefit from the dollar's decline abroad.

We believe that the cyclical low of inflation is occurring this year. Consumer prices are expected to rise 4.4% in 1987 and 5.1% in 1988, compared with an increase of only 1.7% in 1986. The divergence in relative price trends should narrow, and higher inflation will push interest rates upward.

Disparity and the Policy Response

In the two years after the middle of 1984, the U.S. economy slipped into a growth pattern that most characterized as sluggish. Real GNP growth averaged 2.5%, which disappointed many after the nearly 7% annual rate of gain during the first 1½ years of recovery. Few industries or sectors have been following the recent 2.5% growth track, however. Some parts of the economy have been strong, while others have been close to depression.

Several factors have contributed to the current divergence among sectors. Some of these are more cyclical, such as the rise and fall of inflation, interest rates, the dollar, and defense spending. Other forces reflect longer-term, structural shifts in the economy. These include adjustments to the drop in oil prices and overproduction in agriculture, changes in tax policy, deregulation, and the movement of jobs towards higher technology and services. Divergences caused by cyclical forces will tend to narrow more quickly than those due to structural factors.

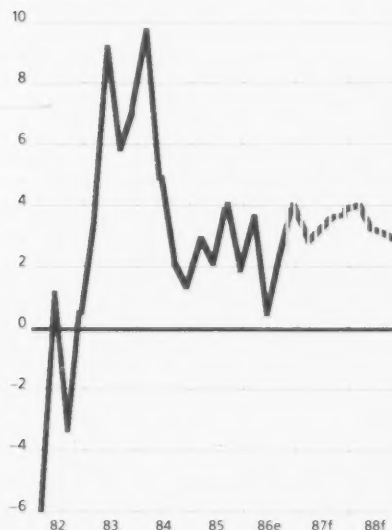
Avoiding the Deficit Issue

Fiscal policymakers have wrestled with the problems of subaverage growth and imbalances, as views on the impact of the deficit have split into three camps. The traditional view is that deficits are expansionary and stimulate economic activity. This thinking took a 180-degree turn in the past few years as reflected in the belief that deficits would drive up interest rates, cause a strong dollar, and therefore depress economic growth. As

3

Pickup in Real GNP

(Percent change from prior quarter, annual rate)



Federal Budget

(Billions of dollars)

	Receipts	Outlays	Deficit
1982	\$618	\$ 746	-\$128
1983	600	808	-208
1984	667	852	-185
1985	734	946	-212
1986	769	990	-221
1987f	822	1007	-185
1988f	898	1068	-170

the threat of Gramm-Rudman actions to reduce the deficit came closer to reality in 1986, a third view emerged. This theory is that deficits stimulate economic activity in the short run, but retard growth in the long run. Because of this view, some economists were concerned about the short-term negative effects of efforts to reduce the deficit.

The Supreme Court's ruling overturning the automatic spending-cut process of the Gramm-Rudman-Hollings measure has eased these latter concerns. The deficit remains at a high level. We forecast that it will equal about \$185 billion in fiscal 1987, following a deficit of \$221 billion in fiscal 1986. In its projection of a deficit of only \$154 billion for fiscal 1987, Congress was not required to include inflation adjustments for various programs, since no appropriations bills had yet been passed. Our estimates show federal spending rising by less than 2% in fiscal 1987, but this reflects some acceleration of spending into fiscal 1986 and sales of federal assets (various loans and Conrail) in 1987. These

sales are counted as one-time reductions in outlays and do nothing to address the problem of longer-term structural deficits.

Will Congress take serious steps to solve the deficit problem during the next two years? Probably not. The size of the deficit and the remaining restraints of Gramm-Rudman are likely to limit the growth of various nonmilitary federal programs. The political constituency for further large increases in defense spending has also now dissipated. The major force which will contribute to a lessening of concern about the deficit during the next two years, however, is likely to be economic growth. Sizable increases in revenue should help narrow the deficit to about \$170 billion in fiscal 1988, although federal spending will still amount to more than 22% of GNP.

Monetary Policy—Weighing the Risks

The response of monetary policy to the imbalances in the U.S. economy and sluggish average growth has been to provide additional stimulus. The growth of M1 (demand deposits and checkable accounts) was 12% in 1985 and is estimated to be 14% in 1986 (fourth quarter-to-fourth quarter). This will far exceed the Federal Reserve's target of a maximum M1 growth of 8% in each of these years. Although not as explosive as M1, all of the other monetary aggregates have also registered rapid growth during the past year.

The Federal Reserve relies on GNP as its primary gauge of the tightness or ease of monetary policy. With inflation still low, the

monetary authorities have perceived relatively little risk in supplying additional liquidity, with the hope that some of that stimulus would filter down to help the more troubled sectors. Early signs of an upturn in inflation are likely to be attributed to various special factors. At the same time, certain sectors of the economy will be slow to strengthen. Although the increase in inflation is likely to be more apparent in 1988, the approaching elections and some moderation in economic growth will prevent any aggressive tightening in that year. Consequently, we expect monetary policy to continue to be expansive during the next two years, with M1 growth of about 9% (fourth quarter-to-fourth quarter) in 1987 and 8% in 1988.

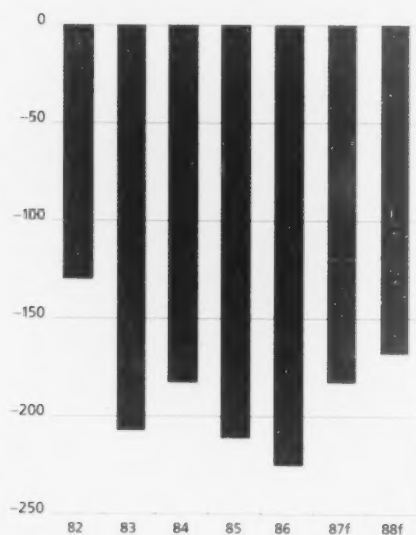
Tax Reform—New Incentives

Tax reform will act to quicken the process of structural change in the U.S. economy by reducing incentives for heavy industry and lowering taxes for the services sector. The ending of the investment tax credit will tend to reduce the share of capital investment in the economy from that which would otherwise have existed. The removal of various tax subsidies and greater equalization of tax burdens among industries should, nevertheless, cause spending and investment decisions to be based more on economic than on tax considerations. This more efficient allocation of resources should lead to higher economic growth in the long run.

The immediate effects of tax reform have been negative for economic growth. Uncertainty held back spending plans earlier in the

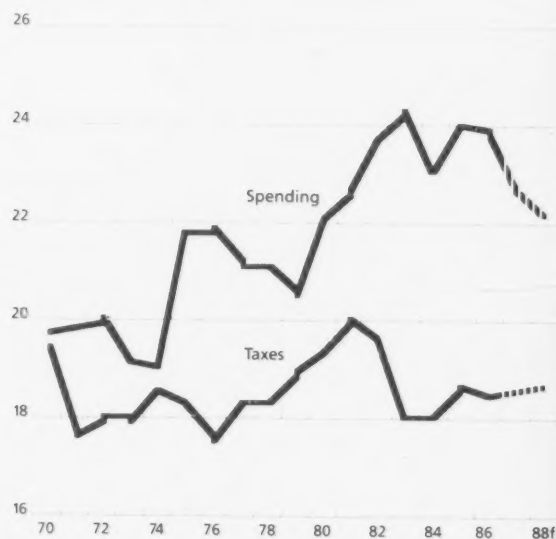
Federal Deficit Still Large

(Billions of dollars)



Efforts to Outgrow the Deficit Problem

(Federal spending and taxes as a percent of GNP)



Plant and Equipment

(Billions of dollars)

	Structures	Equipment	Total
1982	\$143	\$224	\$367
1983	124	233	357
1984	139	277	416
1985	155	303	458
1986e	143	317	460
1987f	137	344	481
1988f	146	377	523

year, and the removal of various building and capital-equipment incentives has further dampened investment in 1986. The reduction in individual and corporate tax rates in 1987 and 1988 should begin to lessen some of these dampening influences.

Consumer spending for big-ticket items is likely to be strong in the latter part of 1986, since individuals will no longer be able to deduct state and local sales taxes after year-end. The loss of preferential treatment for capital gains may help fuel this spending, as individuals sell various assets before the close of the year. This step-up in consumer spending at the end of 1986 may deflect sales from early 1987, although income tax rates will be cut on January 1 (five brackets with a maximum marginal rate of 38.5%). The positive effect of lower tax rates should be more visible in consumer spending as 1987 proceeds and will be enhanced with a further reduction in individual tax rates in 1988. On January 1 of that year, individual tax rates will be reduced to 15% and 28%

(higher-income individuals will pay a marginal rate of 33% above certain income levels).

Tax reform is likely to cause a greater share of sales to be on a cash basis rather than on credit. It will also tend to promote greater consumer spending for nondurables and services, as opposed to durables, which are traditionally financed more through credit. This is because consumers will be allowed to deduct only 65% of their interest expense paid in 1987, 40% in 1988, and zero by 1991. Lower tax rates will also reduce the value of that deduction. Financing innovations to mitigate the limitation on interest deductions can, however, be anticipated.

Although housing will remain as one of the few allowable deductions, lower tax rates will raise the effective after-tax cost of homeownership. Tax reform will thus tend to slightly reduce the growth of new housing construction. Apartment building will be reduced substantially because of much longer depreciation schedules, restrictions on deductions for investment losses, minimum tax provisions, the ending of preferential treatment for capital gains, and restrictions on tax-exempt bonds.

Tax reform has substantially depressed business capital spending in 1986 with the repeal of the investment tax credit retroactively to January 1 of this year. Depreciation schedules will also generally be made slightly less favorable beginning in 1987, while corporations will face a tighter minimum tax. The tax credit for research and development will, however, be extended,

although at 20% compared to the present 25% rate. In addition, corporations will see a reduction in their tax rates from 46% to 34% on July 1, 1987, with blended rates applying for the first half of next year.

Growth Prospects Brighten

During the past 40 years, failure of the U.S. economy to live up to expectations has generally been ascribed to a shortage of demand. Lack of spending in the U.S. economy clearly has not been the problem during the past two years. Between the middle of 1984 and 1986, final sales to American consumers, government institutions, and businesses expanded at an average annual rate of nearly 4% in real terms. Over the same period, production by U.S. firms, as measured by GNP, increased at a real annual rate of just 2.5%. Lower exports and higher imports were primary reasons for this divergence between U.S. spending and output. The dollar's decline since the beginning of 1985, however, should gradually bolster exports, restrain the increase in imports, and narrow the size of the net export wedge.

The other two major constraints on economic growth in 1986 should also be assuaged. Energy producers should benefit from the bottoming out and slight rise in oil prices. Business investment should reflect the resolution of uncertainty over tax reform.

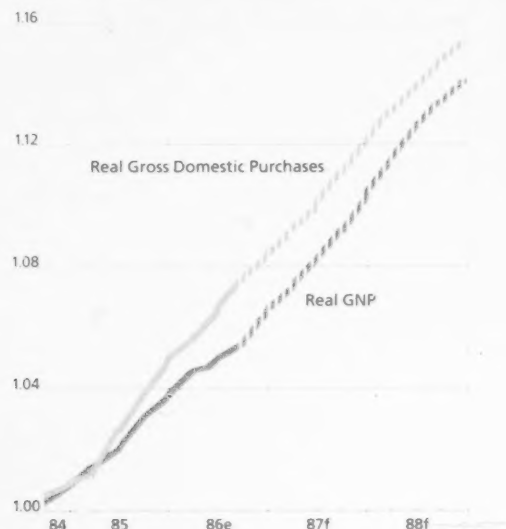
We forecast real GNP to increase 3.6% on a fourth quarter-to-fourth quarter basis in 1987 and 3.4% in 1988. These rates of growth compare with an estimated increase of 2.7%

Expansive Money Growth (M1)

(Three-year average growth rates based on 4th quarter)

**Smaller Wedge Between Demand and Production**

(Cumulative change from 2nd quarter 1984, Index = 1.00)



in 1986. A buildup of auto inventories and tax-induced consumer spending are likely to push up growth in the fourth quarter of 1986 to an annual rate of about 4% and then depress growth in the first part of 1987 to about 3%. Economic growth is projected gradually to accelerate to a peak in the first quarter of 1988, after which the effects of higher inflation and interest rates are expected to moderate the pace of real growth.

Strengths vs. Weaknesses

Consumer spending is anticipated to rise substantially in both 1987 and 1988, supported by an accommodative monetary policy, reductions in individual tax rates, and employment gains. The auto financing incentives introduced in the fall of 1986 should boost total sales for the year to a near-record 11.3 million cars. Total auto sales are likely to move somewhat lower to 11.1 million units in 1987 and 11.0 million in 1988 because of some easing in pent-up demand and the impact of tax reform. Auto makers can be expected to continue to offer various incentives at different points over the two-year period. The major growth areas for consumer spending during the next two years are expected to be in home furnishings (especially in 1987 following the strong housing activity in 1986), nondurables, and services.

Exporters should realize better growth in 1987 and 1988, especially in Europe, because of the lower dollar. Many firms will also benefit from a reduction in import competition

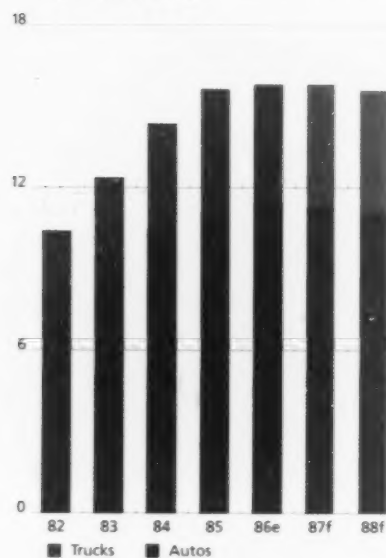
Major Economic Indicators

Major Economic Indicators					Quarterly			
	1986				1987			
	I	II	III	IV	I	II	III	IV
	Actual				Forecast			
Gross National Product (billions of \$, annual rate)	4149.2	4175.6	4234.3	4316.0	4390.3	4472.9	4563.7	4659.7
% Change, annual rate	6.2	2.6	5.7	7.9	7.1	7.7	8.4	8.7
Real GNP (billions of 1982 \$, a.r.)	3655.9	3661.4	3683.3	3720.5	3748.5	3780.0	3815.4	3853.0
% Change, annual rate	3.8	0.6	2.4	4.1	3.0	3.4	3.8	4.0
Real Domestic Final Sales (billions of 1982 \$, a.r.)	3741.9	3800.2	3852.4	3863.5	3886.5	3913.0	3947.4	3981.0
% Change, annual rate	-1.9	6.4	5.6	1.2	2.4	2.8	3.6	3.4
Real Change in Inventories (billions of 1982 \$, a.r.)	39.9	15.1	-4.5	15.0	19.0	23.0	22.0	24.0
GNP Deflator (1982 = 100)	113.5	114.0	115.0	116.0	117.1	118.3	119.6	120.9
% Change, annual rate	2.5	1.8	3.6	3.5	3.9	4.2	4.4	4.5
Consumer Price Index (1967 = 100)	327.7	326.3	329.4	331.9	335.3	338.8	342.5	346.4
% Change, annual rate	1.5	-1.7	2.6	4.3	4.2	4.2	4.5	4.6
Auto Sales (millions, annual rate)	10.7	11.2	13.2	10.1	10.7	11.0	11.6	11.2
Housing Starts (millions, annual rate)	2.00	1.91	1.76	1.79	1.78	1.79	1.77	1.75
Industrial Production (1977 = 100)	125.0	124.4	125.1	126.6	127.9	129.3	130.9	132.7
% Change, annual rate	1.0	-1.9	2.4	4.8	4.2	4.4	5.1	5.6
Nonfarm Employment (millions)	99.4	99.8	100.2	100.9	101.5	102.2	103.0	103.8
Unemployment Rate (percent)	7.0	7.1	6.8	6.6	6.6	6.5	6.3	6.1
Corporate Operating Profits (billions of \$, annual rate)	296.4	293.1	293.0e	296.0	300.0	304.0	309.0	316.0
% Change over year ago	11.3	6.9	-1.1	3.6	1.2	3.7	5.5	6.8
Cash Flow After Dividends (billions of \$, annual rate)	380.9	380.7	381.0e	383.0	385.0	387.0	390.0	394.0
% Change over year ago	5.5	2.7	-0.5	-1.6	1.1	1.7	2.4	2.9
Money Supply (M1) (billions of \$, a.r.)	632.2	657.2	685.7	706.3	723.9	740.0	754.9	769.5
% Change, annual rate	7.9	16.8	18.5	12.6	10.3	9.2	8.3	8.0

NOTE: All quarterly series are seasonally adjusted; % change, annual rate calculated from prior quarter; calculations based on

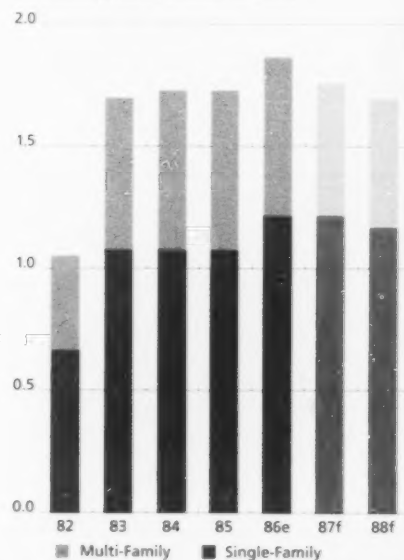
Motor Vehicle Sales Remain Sizable

(Millions of units)



Less Apartment Building Moderates Housing Boom

(Housing starts, millions of units)



1988				% Change		4th Quarter			
I	II	III	IV	1986	'86/'85	1987	'87/'86	1988	'88/'87
Forecast				Estimate		Forecast			
4763.3	4861.1	4959.7	5060.1	4316.0	5.6	4659.7	8.0	5060.1	8.6
9.2	8.5	8.4	8.4						
3892.8	3925.5	3956.5	3984.9	3720.5	2.7	3853.0	3.6	3984.9	3.4
4.2	3.4	3.2	2.9						
4017.8	4046.5	4076.5	4103.9	3863.5	2.8	3981.0	3.0	4103.9	3.1
3.8	2.9	3.0	2.7						
25.0	27.0	26.0	24.0	15.1	N/A	24.0	N/A	24.0	N/A
122.4	123.8	125.4	127.0	116.0	2.8	120.9	4.2	127.0	5.0
4.8	4.9	5.0	5.3						
350.5	354.7	359.2	364.1	331.9	1.7	346.4	4.4	364.1	5.1
4.8	4.9	5.2	5.5						
11.4	11.1	10.9	10.7	11.3*	9.8	11.1*	-1.5	11.0*	-0.9
1.74	1.72	1.71	1.68	1.86*	5.1	1.77*	-4.9	1.71*	-3.4
134.7	136.2	137.3	138.3	126.6	1.5	132.7	4.8	138.3	4.2
6.0	4.5	3.5	2.9						
104.6	105.4	106.2	106.9	100.9	2.3	103.8	2.9	106.9	3.0
6.0	5.8	5.8	5.7	6.6	N/A	6.1	N/A	5.7	N/A
323.0	329.0	335.0	341.0	296.0	3.6	316.0	6.8	341.0	7.9
7.7	8.2	8.4	7.9						
399.0	402.0	406.0	410.0	383.0	-1.6	394.0	2.9	410.0	4.1
3.6	3.9	4.1	4.1						
784.5	799.3	814.9	831.1	706.3	13.9	769.5	8.9	831.1	8.0
8.0	7.8	8.0	8.2						

unrounded data; a.r. = annual rate; e = estimate

*Annual total; N/A = not applicable

or higher prices for products from Japan and countries in Europe.

We estimate that housing will show its best year in eight years in 1986, with 1.86 million new starts. In 1987, we forecast 1.77 million starts, still a healthy level. Single-family building will remain quite strong at 1.20 million units, with the reduction mainly in apartment units because of tax reform and the increase in vacancies. The continued impact of tax reform in 1988 and a rise in mortgage rates are projected to hold total housing starts to about 1.71 million units in that year.

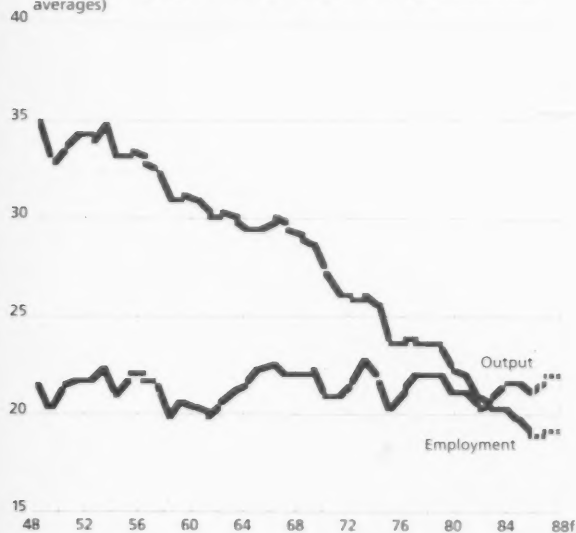
The impacts of severe cutbacks in energy exploration, excess capacity, and tax reform are likely to limit the increase in plant and equipment spending to only 0.3% in 1986. This will produce a decline in real terms of slightly over 1%. In 1987, although nonresidential building will continue to decline because of the surplus in office space and changes in tax laws, we look for a sizable rebound in spending on business equipment, ranging from computers to telecommunications equipment. Business capital spending should be moving from a lower base, depressed in 1986 by less favorable tax laws. Nonresidential building should start to pick up again in 1988 as existing space is absorbed, while another sizable gain in investment in business equipment occurs in that year.

Improving profit margins and better volume should push operating profits (pretax) up about 7% on a fourth quarter-to-fourth quarter basis in 1987 and by nearly

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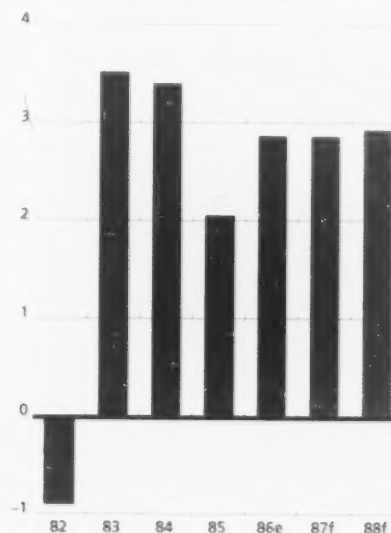
Manufacturing Holds Output Share with Lower Employment Share

(Manufacturing as percent of GNP and non-farm payrolls, annual averages)



Over 17 Million New Jobs

(Change in total employment in millions, household survey, 4th qtr. to 4th qtr.)



8% in 1988. The change in depreciation treatment will result in smaller gains in net cash flow.

Manufacturing—Long-Term or Cyclical Decline?

The decline in manufacturing employment during the first half of 1986 provoked concerns that U.S. factories could never be competitive in world markets even with a sharply lower dollar against certain currencies. In fact, manufacturing employment has been on a downward trend as a share of total nonfarm employment since World War II. Whereas in 1948, 35 out of every 100 non-farm jobs were in factories, by 1985, only 20 out of every 100 employees worked in manufacturing. In contrast, factory output has held a relatively stable 21% to 22% of total GNP since World War II.

The United States cannot be competitive with the labor costs in basic manufacturing in many of the newly industrialized countries, such as Taiwan or South Korea. Its major comparative advantage will be in industries with a higher technology component. Nevertheless, some impact of the dollar's decline against other currencies should mean a slight increase in manufacturing's share of both employment and output by 1988 from the levels of 1986.

Employment Trends Positive

Despite many disappointing aspects of the U.S. economy, the employment record has been highly impressive. Between the end of 1982 and the end of 1986, nearly 12 million

jobs will have been generated in the American economy.

We estimate that, based on the survey of households, slightly less than 3 million jobs will be added in each of the two forecast years, 1987 and 1988. This will mean that 1988 should end with the creation of almost 18 million new jobs over the six years of U.S. economic expansion.

Job growth should be large enough, relative to increases in the labor force, to push the total unemployment rate from an average of about 7.0% in the first half of 1986 to 6.1% by the fourth quarter of 1987 and 5.7% by the end of 1988. At the same time, the proportion of the working-age population able to find employment will reach new highs. We expect 63 percent of the population aged 16 and over to be working by the end of 1988, up from an average of about 61% in the first half of 1986.

Inflation Low Unsustainable

Consumer prices are expected to end 1986 with a fourth quarter-to-fourth quarter increase of only 1.7%. The last time inflation was this low was in 1965, when consumer prices rose 1.8%. As in the case of real GNP growth, the average performance of the consumer price index masks a substantial divergence of the components.

Service Prices Up—Commodities Down

Commodity and service prices have about equal weights in the consumer price index. In 1965, the previous low point of inflation, commodity prices rose by 1.4%, while service

prices increased 2.6%. In 1986, we estimate that the prices of various goods will decline an average of about 1.5%, while service prices climb 5.1%. Energy prices have plunged, while many other goods prices have edged up only modestly. Prices of different services, ranging from medical care to education to insurance, have continued to advance at an average rate of 5.0% to 5.5% during the past three years and show no signs of decelerating.

In order to retain the 1986 rate of inflation, another year of deflation in commodity prices would be necessary. Oil producers have borne the brunt of decline in 1986, as consumers saw energy prices plummet by more than 20% during the year. No other sector is likely to experience that kind of price decline in 1987. In contrast, more groups are lobbying for higher prices for their output. Consequently, there is little political support for maintaining the lowest inflation rate in two decades.

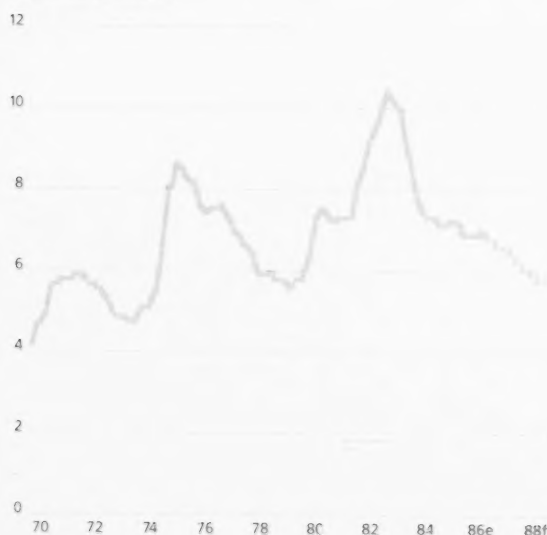
Inflation Passes its Cyclical Low

We expect inflation to move higher through 1987 and 1988. On a fourth quarter-to-fourth quarter basis, our forecast is for an increase in consumer prices of 4.4% in 1987 and 5.1% in 1988. The rapid growth of money is likely to most quickly and directly affect service prices. On a fourth quarter-to-fourth quarter basis, we expect a 5.6% increase in 1987 and a rise of about 6.0% in 1988.

Our assumption is that oil prices will gradually move upward during the next two

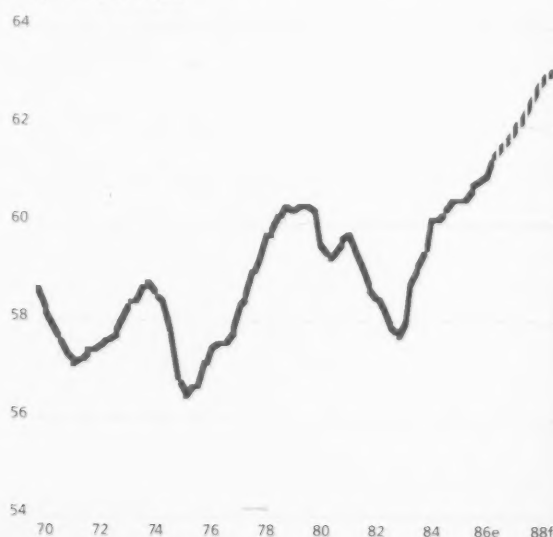
Jobless Rate to Ease Downward

(Unemployment as percent of total labor force, quarterly averages)



Record Share of Population Employed

(Percent of population age 16 and over holding jobs, quarterly averages)



Consumer Prices, Wages and Salaries

(Percent change, 4th quarter-to-4th quarter)

	Consumer Prices*	Wages & Salaries**
1981	9.6	8.8
1982	4.5	6.3
1983	3.3	5.0
1984	4.1	4.1
1985	3.5	4.1
1986e	1.7	3.8
1987f	4.4	4.2
1988f	5.1	4.8

*All urban **Private sector

years mainly on the basis of stronger demand. Under this assumption, oil prices would rise from an average of about \$15.00 per barrel (West Texas Intermediate) in the fourth quarter of 1986 to \$15.50 by year-end 1987. Oil prices then would keep pace with the general pace of inflation, rising to \$16.25 by the end of 1988. We expect food prices to show an increase of somewhat less than 3% in 1987 and about 3.5% to 4.0% in 1988.

The effect of money growth and the dollar's depreciation should start to be reflected in the prices of various goods during the next two years. Although many firms will take advantage of stronger demand to expand production, others will also attempt to boost profit margins. The increase in corporate taxes will reinforce this trend. We expect the prices of consumer goods to reverse their 1986 decline and show a fourth quarter-to-fourth quarter gain of about 3.2% in 1987

and 4.0% or slightly more in 1988.

Wages—Some Tightening in Labor Markets

Considerable disparity has also characterized wage trends. Whereas wages and salaries in the total private sector have risen an average of about 3.8% in 1986, increases have ranged from 5.5% in the Northeast to 2.7% in the Midwest. Stronger demand for U.S.-made goods and tighter labor markets are likely to result in somewhat larger wage increases in 1987 and 1988. Employee give-backs are likely to be much more rare, and the overall increase in private wages and salaries is forecast to average 4.2% in 1987 and 4.8% in 1988.

**Interest Rates—End of the Decline
Faster Growth to Push Short-Term
Rates Higher**

Two major factors will determine the trend of short-term interest rates over the next two years: (1) the growth of nominal GNP and (2) the stance of Federal Reserve policy. Indications of faster GNP growth will indicate to financial markets the possibility of higher inflation, stronger credit demand, and a more restrictive monetary policy. We expect an acceleration in nominal GNP growth, on a fourth quarter-to-fourth quarter basis, from about 5.5% in 1986 to 8.0% in 1987 and slightly over 8.5% in 1988.

The Federal Reserve is now focusing on the federal funds rate or its proxy, the level of borrowings from the central bank, as the principal control variable for monetary policy. Because of concern over the value of

the dollar, the Federal Reserve is unlikely to take any further unilateral action to push short-term interest rates lower. If the economy strengthens as we expect, an effort to hold interest rates below market levels would produce an acceleration in money growth on top of the rapid expansion which has already occurred. Consequently, although the Federal Reserve is unlikely to take the lead in driving interest rates upward during the next two years, it will only try to temper the rise and follow the market upward. This will be especially true in 1987, until there is clearer evidence that faster growth in the economy is taking hold.

Our forecast indicates a comparatively modest increase in short-term interest rates through 1988. We expect about a 100-125 basis-point increase between the fourth quarter of 1986 and the fourth quarter of 1987, with another one percentage-point rise in 1988. This would take the average rate on three-month Treasury bills from an estimated average of 5.40% in the fourth quarter of 1986 to 6.60% in the final quarter of 1987 and 7.50% in the last quarter of 1988. Over the same period, the bank prime rate would rise from 7.50% at the end of 1986 to 8.75% by December 1987 and 9.70% by year-end 1988. To place these interest rate levels in perspective, Treasury-bill rates averaged nearly 8.2% and the prime rate was about 10.5% in the first quarter of 1985.

Bond Markets Grow More Nervous

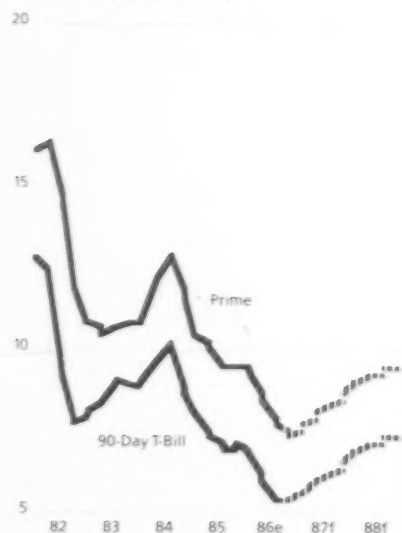
Three primary forces will dictate the level and direction of long-term interest rates: (1)

Inflation Higher After 1986

(Percent change in consumer prices, 4th quarter to 4th quarter)

**Short-Term Rates Respond to Faster Growth**

(Percent, quarterly averages)



Forecast of Interest Rates 1986-1988

	1986				1987				1988			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Short-Term	Actual				Forecast							
Fed Funds (Overnight)	7.83	6.92	6.21	5.93	6.15	6.45	6.75	7.05	7.55	7.75	7.95	8.10
Treasury Bills (3 month) ⁽¹⁾	6.90	6.14	5.52	5.40	5.65	6.05	6.35	6.60	7.05	7.25	7.40	7.50
CDs (3 month, Secondary)	7.58	6.66	6.00	5.95	6.25	6.60	6.90	7.20	7.65	7.85	8.00	8.10
Eurodollar (3 month)	7.77	6.88	6.29	6.15	6.50	6.85	7.15	7.45	7.90	8.15	8.30	8.40
Prime Rate	9.37	8.61	7.85	7.50	7.83	8.13	8.45	8.75	9.20	9.45	9.60	9.70
Long-Term												
U.S. Government Bonds (30 yrs) ⁽²⁾	8.76	7.49	7.41	7.85	8.00	8.25	8.55	8.85	9.15	9.25	9.35	9.45
Corporate Aaa (Moody's)	9.57	9.00	8.83	9.05	9.20	9.50	9.80	10.00	10.25	10.35	10.45	10.50
Mortgage Rate (Fixed) ⁽³⁾	10.56	10.25	10.24	10.10	10.30	10.65	10.90	11.15	11.35	11.45	11.55	11.65

(1) Bank discount basis.

(2) Yields adjusted to constant maturities.

(3) Contract rates on first mortgages, conventional market.

the real (after-tax) return on capital, (2) the expected rate of inflation, and (3) the amount of uncertainty about the future. The anticipation and subsequent enactment of tax reform caused a reduction in investment demand in 1986 and pushed the real return on capital lower. Concerns about higher inflation, however, emerged in late summer with the dollar's continued slide and the rise in certain commodity prices, especially gold. The market had become so sensitized to inflation that, despite three cuts in the discount rate between April and September, long-term interest rates moved higher. By September, the yield curve had steepened considerably, reflecting the anticipation of higher interest rates in the future.

We expect some further increase in expected inflation to occur as the actual inflation rate moves up from less than 2% in

1986 to slightly over 5% by the end of 1988. There is also likely to be an increase in the risk premium for uncertainty over the future course of monetary policy, fiscal actions, and the dollar.

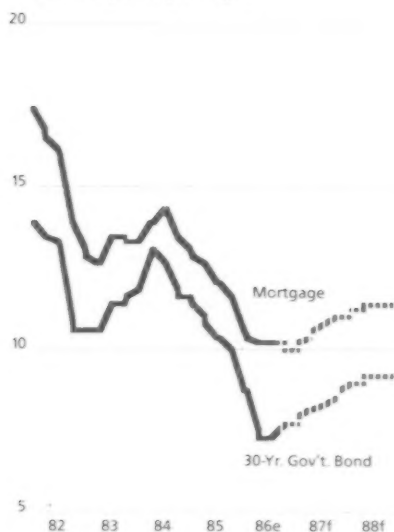
Our forecast is for long-term interest rates to increase about one percentage point from the average levels of the final quarter of 1986 to the end of 1987, with another rise of about 50-60 basis points in 1988. This implies that the major steepening of the yield curve will have been completed in 1986, with basically a parallel shift upward in 1987. We then expect some flattening to occur in 1988 as short-term interest rates rise faster than long-term rates. By that time, more of the increase in expected inflation will have already been incorporated into long-term bond yields, while rising credit demands and monetary policy will produce

a larger rise in short-term rates.

We expect the yield on 30-year government bonds to move from an average of 7.85% in the fourth quarter of 1986 to 8.85% by the fourth quarter of 1987 and 9.45% by the end of 1988. In such an environment, mortgage rates on 30-year fixed-rate loans would increase from an average of 10.10% in the fourth quarter of 1986 to 11.15% by the end of 1987 and 11.65% by the last quarter of 1988. An easing in the processing backlog for mortgage applications should produce some narrowing in the spread of mortgage rates over long-term government bond yields. As interest rates rise, however, the expected preference of many lenders for variable over fixed-rate loans is expected to lead to more favorable pricing for adjustable as opposed to fixed-rate mortgages.

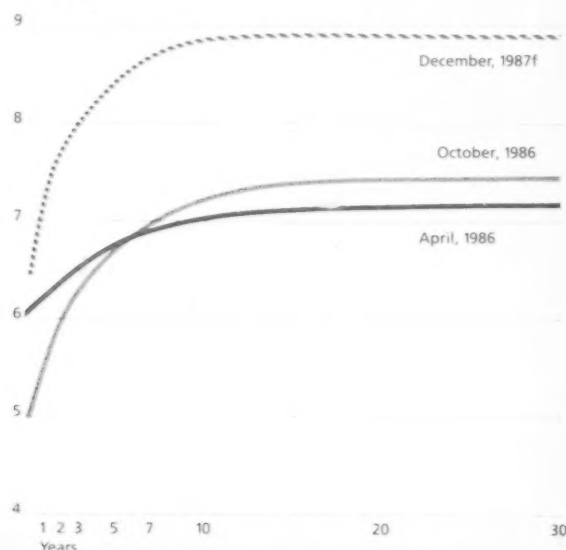
Long-Term Rates Reflect Higher Expected Inflation

(Percent, quarterly averages)



Yield Curve of Government Securities to Shift Upward

(Percent)





During the recent economic expansion, shocks, particularly in agriculture and energy, have contributed to shifts in regional growth patterns. Disparities exist between high-growth states, which are those with diversified economies located in the Far

West and the East, and states experiencing slow growth, which are primarily dependent upon a single-resource base.

Three of the nation's fastest growing states are located in FI Territory—Arizona, Nevada, and Utah. Several of the nation's energy-dependent states (Alaska, Montana, North Dakota, Oklahoma and Wyoming) are also located in the Territory and will continue to face adjustments during the forecast period.

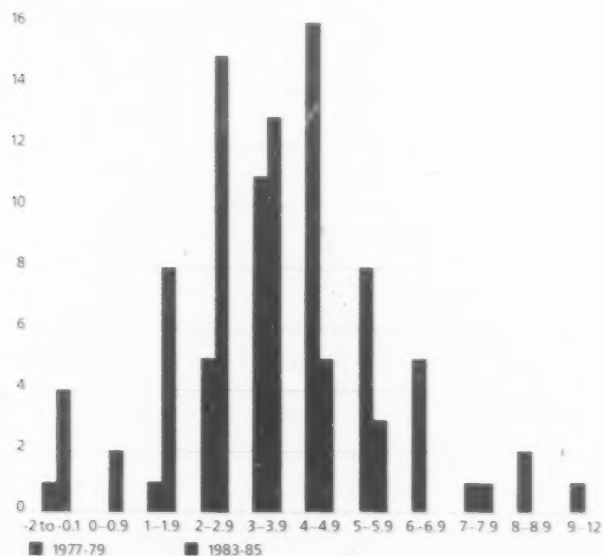
Disparities Mark Regional Performance

During the first three years of the current economic expansion (1983-1985), employment in the United States increased at an average annual rate of 2.8%, while nominal personal income increased 7.6% per year. These numbers are weighted averages of state income and employment growth—some states growing at a faster and some at a slower rate. The greater the divergence around the U.S. average, the greater the concern: high growth in some states disguises the degree of slow growth or decline in others. In addition, changes in the regional groupings of high- and low-growth states suggest changes in fundamental economic conditions in some of these states.

Employment Growth Moves to Southwest and East

The two maps on the following pages show the geographic distribution of employment growth for the recent economic expansion (1983-85) and for a comparable three-year period in the previous expansion (1977-79). In the earlier period, employment growth was highest in the South and the West, reflecting the shift in population and economic influence from the "frostbelt" to the "sunbelt." These regions experienced substantial population increases through net immigration from the Northeast and the Midwest as people pursued expanding economic opportunities in Southern and Western states. Employment growth in the Far West, particularly California, was fueled

Distribution of Employment Growth Shifts
(Number of states by percent annual growth)



by increases in aerospace, defense and solid-state electronics. Shifts in energy sources, lower labor costs, and improvements in highways, airports, schools and universities fueled growth in the South, resulting in an overall net migration to the South double that to the West from 1975 to 1980.

In the most recent period (1983-85), Southern and Western states continued to experience high population growth, with the greatest increases occurring in Alaska (17%) and Arizona (10%). As indicated by the map, however, the centers of high employment growth shifted to the Far Southwest and East Coast.

The distribution of employment growth in the two periods is shown by the graph on the preceding page. It is evident that the whole distribution has shifted downward from the first to the second period, illustrating that the rate of employment growth was higher during the 1977-79 period than during 1983-85. In addition, more states were clustered in the low, and fewer in the high, range of growth during the later period. During 1977-79, annual employment growth ranged from -0.9% to 11.1%. Only Alaska showed a negative growth rate, while the remaining states showed positive growth of over 1%. In contrast, employment growth during 1983-85 ranged from -2.0% to 7.4% and a total of six states had growth rates under 1% (Wyoming, Oklahoma, West Virginia, Louisiana, North Dakota, and Montana). During 1977-79, nine states had employment growth rates above 6%, compared to only one, Arizona, during 1983-85.

Although it appears that the centers of high employment growth have shifted to the two "coasts," the chart on page 14 illustrates that only four of the states that moved into the "high-growth" category in the 1983-85 period actually grew at rates faster than in the previous period. The group of states analyzed in the chart are those classified as high-growth during the current expansion. This high-growth group is made up of states that were high-growth in both periods as well as those that were classified as high-growth only in the second period. The states that became high-growth in the second period are marked with asterisks; the majority of them are in the East. The bars in the graph represent the difference in growth rates between the two time periods.

Only three of the states that became high-growth in 1983-85—Alaska, Delaware and New Jersey—grew at rates greater than during the earlier period. This change is significant, however, because each of these states was classified as low-growth during the earlier period. Alaska, for example, ranked 50th in employment growth during the earlier period and moved up to fifth during 1983-85. Delaware ranked 46th and New Jersey 42nd in the earlier period and 7th and 14th, respectively, in the later period.

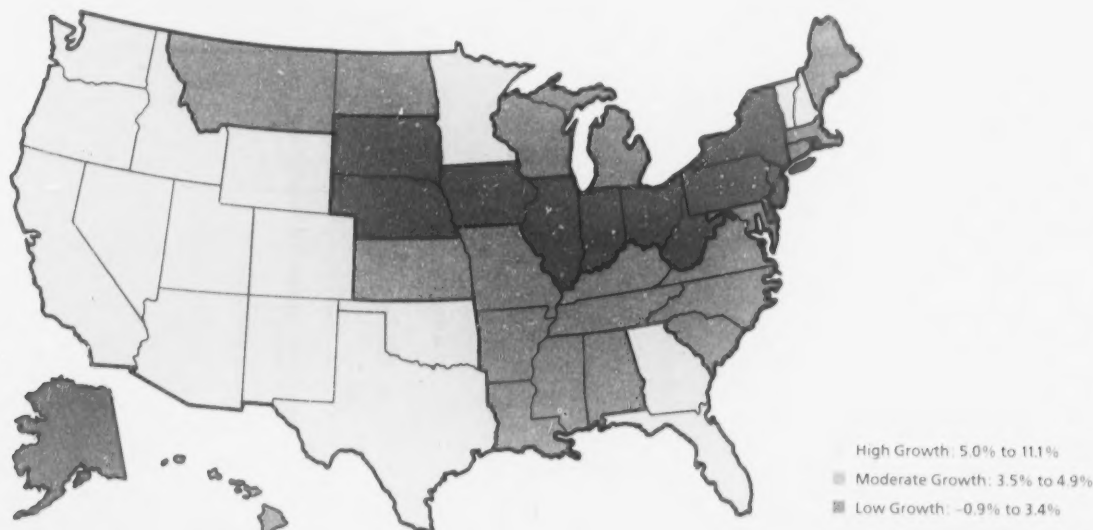
The remaining six states that became high-growth areas in the second period (Arkansas, Massachusetts, South Carolina, North Carolina, Maryland and Virginia) ranked as middle-growth states during 1977-79. During 1983-85 they grew at rates equal to, or slightly less than, during the previous

period, and yet they ranked as high-growth. In other words, levels of growth that ranked as middle-growth in the first period represented high growth in the second, and these states became high growth by basically holding their own between the two periods.

Nevada, Utah, California, Arizona, Florida, Georgia, and New Hampshire were high-growth states in both periods. Of these states, only Georgia grew faster in the second than in the first period. All the others showed a deceleration between the two periods, yet still ranked as high growth. Nevada is particularly noteworthy because it continued to rank as high-growth despite the fact that growth in the second period was 7.5 percentage points less than in the first period. Nevada's growth in the first period was exceptionally strong—the state ranked first in the nation with a rate of 11.1%. By the second period, it ranked 15th with a growth rate of only 3.6%.

Ten states (Wyoming, Washington, Colorado, Oregon, Texas, New Mexico, Vermont, Oklahoma, Minnesota, and Idaho) that ranked as high-growth during the 1977-79 period slipped out of that category in the second period because of significant deceleration in their employment growth rates. Wyoming and Oklahoma experienced the greatest declines—down 10.6 and 6.3 percentage points, respectively, between the two periods. In the earlier period, Wyoming ranked third, with a growth rate of 8.6%, and Oklahoma ranked 14th, with a rate of 5.3%. In the 1983-85 period, both these

**High and Low Growth States
Nonfarm Employment, 1977-1979**
(Average Annual Compound Growth Rate)



states ranked as low-growth states—Oklahoma was 49th with a growth rate of -1.0% and Wyoming 50th with a rate of -2.0%.

This analysis illustrates that, although there has been a shift in the centers of high employment growth from the "sunbelt" to the "coasts," this shift is not the result of accelerated growth in the eastern states. Those eastern states that became high-growth in the second period did so because they maintained comparable growth rates in the two periods, while other states decelerated around them.

Income Growth Patterns Also Shift

Income is another measure of state and regional economic performance. Nominal-income growth for 1977-79 ranged from 3.4% to 18.7% (excluding one exceptionally low growth state, Alaska at 3.5%), while the range for 1983-85 was 2.4% to 10.8%. This would seem to suggest that income growth was much higher in the earlier than in the later period. During the 1977-79 period, however, inflation was much higher than during the subsequent period. If the effect of inflation is taken out, the range of the distribution of real-income-growth changes is dramatically different (see the graph and table on the following page). Most importantly, the graph shows that the range and distribution of growth in real income was similar in the two periods. For example, four states had growth in real income below 1% during 1977-79, compared to five states during 1983-85. At the same time, three states had growth in real income

above 7% in the first period, compared to two states in the second period.

Usually, changes in state employment should be reflected in changes in state real income. The correlation between the two variables, however, is not one-for-one, because employment measures the number of people working and income measures the wage rate times the number of hours worked by those people employed as well as other sources of income. Therefore, those states in one category of employment growth may not be in the same category for income growth, although general regional trends should be similar between the two variables.

During the 1977-79 period, the states with the highest real-income growth were located in the West and the South. Those states with the lowest real-income growth rates (excluding Alaska and Illinois) were located in the East. During the more recent period, high income growth shifted to the East and the Far West. These trends generally follow the regional changes that occurred in employment growth in the two periods.

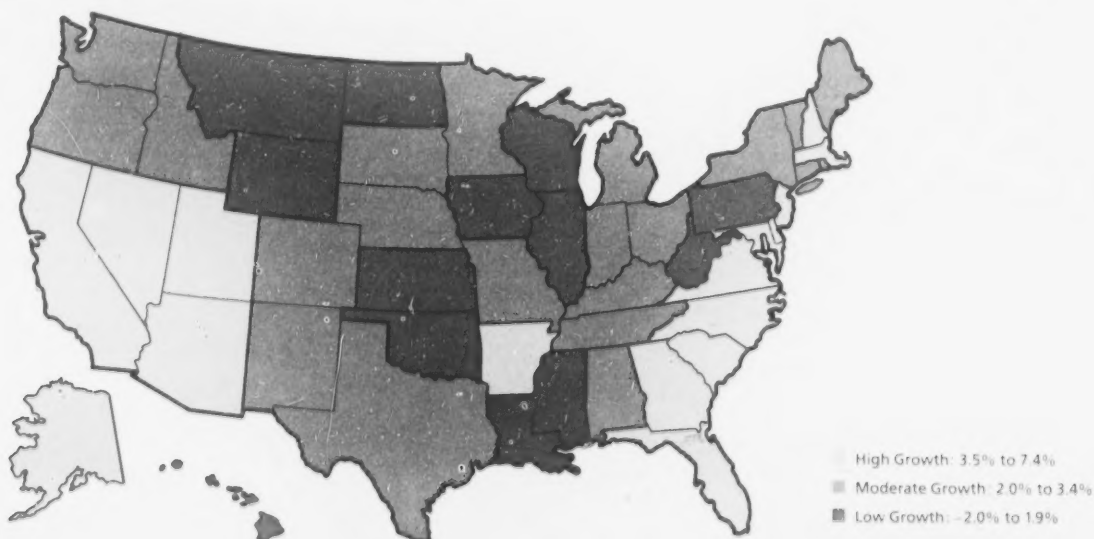
Between the two periods, Massachusetts and Maryland moved from low to high real-income growth. Washington, Oregon, Wyoming, and Oklahoma ranked as high real-income-growth states in the first period, but slipped to low growth during 1983-85. Wyoming, with a growth rate of 9.1%, ranked second during 1977-79. In stark contrast, the state ranked 50th during 1983-85 at -0.9%.

Factors Affecting Changes in Regional Growth Patterns

There are several explanations for regional shifts in economic performance such as those that occurred between the two economic expansions. These explanations include shifts in migration patterns, regional relocation of firms in response to cost and market shifts, and shifts in demand for commodities in which states are specialized. The regional shifts that occurred between the 1977-79 and 1983-85 periods may best be described as the result of economic shocks—those unforeseen events that affected the nation's competitive position in the world economy, as well as the various regions' competitive positions in the U.S. economy. These shocks include significant changes in prices for commodities (especially energy and food), foreign exchange rates, policy objectives, and technological discoveries. The recent declines in oil prices are dramatic shocks that are obvious to all observers.

In many respects, the economic adjustments of the 1980s are the reverse side of the adjustments of the 1970s. Both periods have been characterized by major fluctuations in basic commodity prices—up in the 1970s and down in the 1980s. These fluctuations ripple through the economy. They change the relative regional costs of production—labor costs, as workers try to maintain their standard of living, and input costs, as producers expand or contract production. High and rising energy prices in the 1970s contributed to high income and employ-

**High and Low Growth States
Nonfarm Employment, 1983-1985**
(Average Annual Compound Growth Rate)



High and Low Real Personal Income Growth

(Percent, annual rate)

	Real Income Growth 1977-1979		Real Income Growth 1983-1985	
High	Nevada	9.4	New Hampshire	7.2
	Wyoming	9.1	Arizona	7.0
	Arizona	7.4	Georgia	6.5
	Florida	6.0	Florida	6.1
	Colorado	5.8	Massachusetts	5.7
	Washington	5.6	Virginia	5.5
	Texas	5.6	Nebraska	5.2
	New Hampshire	5.4	Maryland	5.2
	Utah	5.3	North Carolina	5.2
	Oklahoma	5.1	Connecticut	5.1
Low	Oregon	5.1	California	5.0
	Maryland	1.9	Iowa	2.9
	Maine	1.8	Pennsylvania	2.4
	Massachusetts	1.8	Mississippi	2.3
	Illinois	1.7	Kentucky	2.3
	Rhode Island	1.6	Washington	2.1
	Pennsylvania	1.4	Montana	1.0
	New Jersey	1.2	Louisiana	0.6
	Delaware	0.7	West Virginia	0.4
	New York	0.3	Oklahoma	0.2
	Alaska	-4.6	Wyoming	-0.9
	U.S.	3.2	U.S.	4.1

Note: High real income growth defined as greater than 5%; low real income growth defined as less than 2% in 1977-79 and 3% in 1983-85.

ment growth in Alaska, Texas, Oklahoma, Wyoming, and Colorado. Conversely, low energy prices have contributed to these states' slower growth in the 1980s. High

energy prices contributed to slow growth in the Northeast, where disproportionately more fuel oil is used than in other regions. Thus, it is no surprise that the Northeast is

one of the regions that should reap advantages from the recent decline in fuel prices.

Rising agricultural prices contributed to growth particularly in the Midwest, as high commodity prices were capitalized into land values. The present low growth in Iowa is attributable to recent changes in commodity prices and is reflected in major declines in farmland values. Changes in lumber prices have affected economic growth in Oregon and Washington.

In addition to commodity-price shocks, regional economic growth has been influenced by changes in the role of U.S. manufacturing. Growth in employment in the service sector and relative declines in employment in manufacturing industries are well documented. Only part of the cyclical losses in employment during the 1981-82 recession have been recovered; manufacturing employment has not regained 1979 levels. As indicated in the U.S. Economy section, while manufacturing employment is down, manufacturing output has maintained its output share because of increases in productivity. The declines in manufacturing employment, therefore, do not necessarily mean a deindustrialization of the United States. They do mean, however, low employment growth in states with heavy industrial economic bases, such as those in the Middle Atlantic and East North Central regions.

The factors contributing to recent low growth in particular states are readily identifiable, while factors contributing to high growth in other states are somewhat more obscure. This situation may be a result of the

Only Four of High Growth States Grew Faster in Second Period

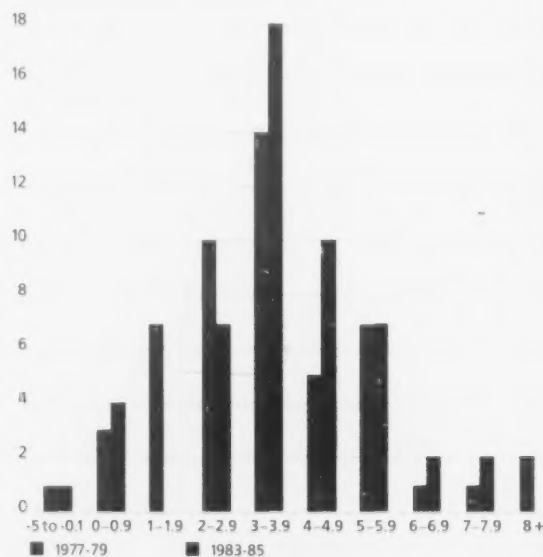
(Difference between 1977-79 & 1983-85 employment growth rates, percentage points)



*Moved to high growth category in 1983-85

Distribution of Real Income Growth Little Changed Between Two Periods

(Number of states by percent annual growth)



fact that those states best able to weather recent economic shocks have diversified economies not highly dependent on one particular employment sector or commodity for growth. California, Arizona, and New Hampshire are examples of high-growth states that have relatively diversified economies. Declines in the California agricultural and oil sectors have been offset by increases in other sectors. New Hampshire has ranked high in growth in manufacturing, trade, and services.

New England is a recent example of dramatic regional economic expansion. Its growth has been driven by defense spending, high-tech manufacturing and services, and aerospace. New England winters have never attracted streams of migrants; most of the economic development thus far has occurred without significant in-migration. Many of the region's new firms are small and local start-ups. They almost never involve relocation from another region. New England per capita income is generally higher than the national average, in part because of a traditionally high labor-force participation rate, including a high proportion of women in the workforce. Three major factors have been identified as important in the New England experience: strong research and scientific facilities, industrial experience, and financial resources. Because scientific manpower tends to be in short supply, high-tech firms cluster around academic centers. New England has historically been on the cutting edge of technology and has a tradition of industrial innovation. In

addition, New England has been a center of venture capital. The lack of venture capital in other regions such as the Southeast has been identified as a restriction on growth. Furthermore, state governments have improved the business environment by reducing taxes, particularly in Massachusetts.

The New England experience highlights several important factors concerning growth. States should not feel helpless in the face of negative external factors. Recent regional employment growth generally has not come from firm relocation or from large companies. It has come from the formation of new firms or the expansion of existing ones (both domestic and foreign). In addition, small businesses have accounted for much of the recent job expansion. Universities have been a focus of development not only in New England (for example, the Massachusetts Institute of Technology and Harvard), but also California (Stanford) and Pittsburgh (Carnegie-Mellon).

High-tech has been a major source of growth for these latter states. There are, however, storm clouds on the horizon. While research and development have remained primarily in New England and California, manufacturing has migrated elsewhere—abroad or to other states.

The regional location of growth is determined by the characteristics of expanding industries. Industries based on natural resources, for example, must be region-specific—mining occurs where the relevant minerals are concentrated. The characteristics of many of the recent growth sectors

make firms in these industries much less location-specific than traditional sectors. Finance, insurance and real estate, for example, is a rapidly expanding sector, and advancements in telecommunications provide flexibility in where firms in this industry, particularly insurance and certain credit services, can locate. Therefore, factors other than the natural resource base of the region will influence future growth patterns even more than in the past.

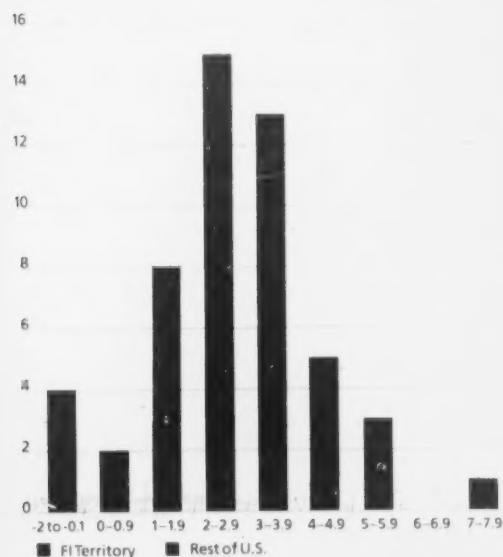
Regional changes resulting from slow growth itself may in time become a factor for future growth. Declines in wage rates relative to other areas or reductions in real estate values, for example, all the result of slow growth, may make a region attractive to expanding industries. These factors played a role in the growth of the South and recently in New England, even without the impact of energy-cost swings.

First Interstate Territory More Varied

First Interstate Territory comprises 18 states, stretching from Hawaii and Alaska in the west to Indiana in the east. Forecasts of these states' nonfarm payroll employment and personal income growth are presented in the table on page 17. Detailed discussions of each state, however, are presented in special *Regional Economic Updates* that are available separately from First Interstate Economics. An overview of forces both similar to and different from those affecting the 50 states in the nation as a whole is presented below.

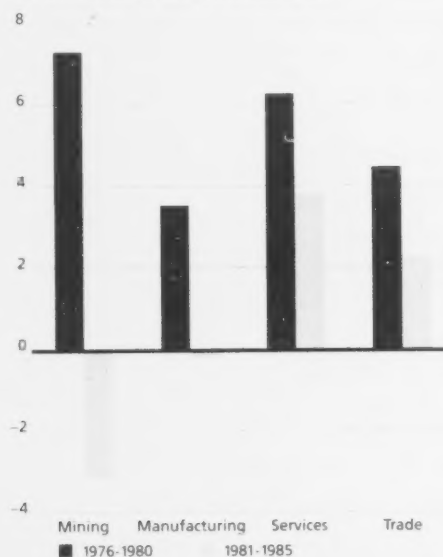
FI Territory Employment Growth More Varied than U.S.

(Number of states by percent annual growth, 1983-85)



FI Territory Employment Declines in Key Sectors, Grows in Others

(Percent change, average annual rate)



Comparisons with National Disparities

The chart on page 15 indicates that the economic performance of states in First Interstate Territory was somewhat more varied in the 1983-85 period than that of the nation as a whole. Furthermore, there was a slightly higher percentage of states at the lower end in the Territory than in the nation. This situation was the opposite of that existing in the 1977-79 period, when the energy and agriculture industries were so robust.

As a collection of states, First Interstate Territory reflects some of the national disparities. California—accompanied by the adjoining states of Arizona and Nevada—has enjoyed solid to extremely high growth rates during the upswing following the 1981-82 recession. In contrast, some of the interior Rocky Mountain states have been experiencing major downturns associated with the collapse of energy and mineral prices and the continuing difficulties of the farm sector.

During the 1977-79 period, the states with significant energy sectors grew much more strongly than the rest of the country. Texas and Louisiana were the only states outside First Interstate Territory that enjoyed such boom conditions.

Disparity describes the varied performances of the states in the Territory. Not only did the Territory states exhibit diverse rates of growth, but the states with the more diverse economic bases outperformed those with a heavy reliance on one or two key sectors.

As can be seen from the graph on the preceding page, during the 1976-80 period,

mining employment was expanding at an annual rate of almost 8%, as oil, gas, coal and metal prices steadily rose and exploration activity soared. This boom in the mining sector was a driving force in promoting manufacturing, service and trade employment growth in 11 of the 18 Territory states during this period. The Territory's aerospace and high-tech-oriented manufacturing base was also a major contributor to the Territory's above-average gains in service and trade employment.

Beginning with the 1981-82 recession, however, oil and other commodity prices began their fall (see accompanying chart), bringing a sudden and dramatic turn in the fortunes of several FI Territory states. These price declines, combined with the 1985-86 slump in the computer and semiconductor industries, resulted in declines in both mining and manufacturing employment in FI Territory. The service and trade sectors continued to experience moderate gains during the 1981-85 period, offsetting the employment losses in mining and manufacturing, but also experienced slower rates of growth than in the previous five years.

Sharply lower oil prices during 1986 have rapidly affected housing construction in FI Territory's energy-dependent states, particularly Alaska, Montana, North Dakota, Oklahoma, and Wyoming (see housing permits table). These states suffered large housing-permit declines, even with the reduction in mortgage interest rates in 1986. Despite a stronger national economy in 1987, little improvement is expected in the hous-

Housing Permits in FI Territory

	1985	1986e	% Change
Alaska	4,029	1,900	-52.8
Arizona	71,820	63,000	-12.3
California	263,282	285,000	8.2
Colorado	32,824	30,000	-8.6
Hawaii	7,262	7,500	3.3
Idaho	4,307	4,200	-2.5
Indiana	23,016	27,000	17.3
Iowa	5,190	5,500	6.0
Montana	2,034	1,200	-41.0
Nevada	14,004	15,500	10.7
New Mexico	11,790	11,000	-6.7
North Dakota	2,641	1,500	-43.2
Oklahoma	10,670	8,700	-18.5
Oregon	10,707	9,800	-8.5
Utah	16,525	15,000	-9.2
Washington	35,474	37,000	4.3
Wisconsin	20,151	21,500	6.7
Wyoming	1,167	900	-22.9

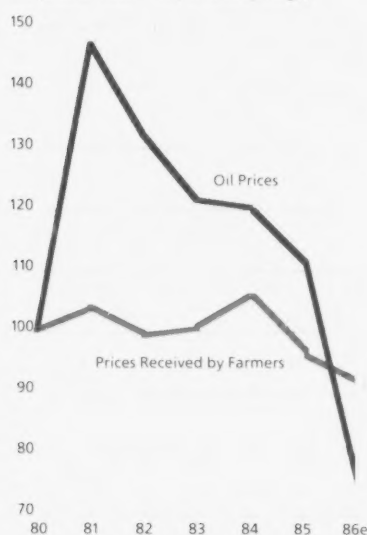
ing-construction sectors in these states; in fact, some states may experience further declines.

High- and Low-Growth States

The diverse economic performances of the states are likely to continue during the next two years. Overall, the Territory will come close to, but not quite catch up with, the national growth rates of employment and personal income. The states that are highly dependent on natural resources, including energy, mineral mining, and agriculture, are expected to see their rates of decline slow.

Commodity Prices Continued Their Downward Trend

(Index: 1980 = 100, annual average)



First Interstate Territory State Forecasts

Nonfarm Employment

	1985		Estimate 1986		Forecast 1987		Forecast 1988	
	Thousands	% Change	Thousands	% Change	Thousands	% Change	Thousands	% Change
Alaska	231	2.5	229	-1.0	226	-1.5	226	0.0
Arizona	1,278	8.1	1,343	5.1	1,396	4.0	1,459	4.5
California	10,965	3.7	11,272	2.8	11,599	2.9	11,947	3.0
Colorado	1,422	1.4	1,444	1.5	1,473	2.0	1,517	3.0
Hawaii	423	2.5	430	1.7	439	2.0	449	2.4
Idaho	338	2.4	339	0.3	341	0.6	346	1.3
Indiana	2,177	2.6	2,253	3.5	2,309	2.5	2,379	3.0
Iowa	1,074	-0.1	1,079	0.5	1,088	0.8	1,104	1.5
Montana	278	-1.0	277	-0.6	277	0.0	278	0.5
Nevada	446	4.6	463	3.8	481	4.0	503	4.6
New Mexico	518	3.0	524	1.1	537	2.5	553	3.0
North Dakota	251	-0.5	249	-0.7	249	0.0	252	1.0
Oklahoma	1,180	0.0	1,161	-1.6	1,158	-0.3	1,175	1.5
Oregon	1,029	2.2	1,053	2.3	1,077	2.3	1,104	2.5
Utah	624	3.8	640	2.6	658	2.8	680	3.3
Washington	1,708	2.9	1,762	3.2	1,806	2.5	1,857	2.8
Wisconsin	1,977	1.4	2,016	2.0	2,063	2.3	2,120	2.8
Wyoming	205	0.5	200	-2.5	198	-1.0	198	0.0
First Interstate Territory	26,125	2.9	26,735	2.3	27,375	2.4	28,147	2.8
U.S.	97,614	3.3	100,152	2.6	102,656	2.5	105,838	3.1

Personal Income

	1985		Estimate 1986		Forecast 1987		Forecast 1988	
	Millions	% Change	Millions	% Change	Millions	% Change	Millions	% Change
Alaska	\$ 9,476	4.4	\$ 9,666	2.0	\$ 9,955	3.0	\$ 10,453	5.0
Arizona	40,775	10.4	43,711	7.2	47,557	8.8	52,313	10.0
California	423,566	8.4	450,674	6.4	486,728	8.0	531,507	9.2
Colorado	47,859	6.1	50,013	4.5	52,663	5.3	56,350	7.0
Hawaii	14,558	6.3	15,213	4.5	16,111	5.9	17,335	7.6
Idaho	11,173	6.2	11,396	2.0	11,852	4.0	12,469	5.2
Indiana	68,442	4.9	72,206	5.5	77,405	7.2	84,062	8.6
Iowa	36,315	3.5	37,041	2.0	38,819	4.8	41,343	6.5
Montana	9,067	1.6	9,203	1.5	9,525	3.5	9,982	4.8
Nevada	13,560	7.6	14,401	6.2	15,553	8.0	17,077	9.8
New Mexico	15,828	6.7	16,382	3.5	17,283	5.5	18,493	7.0
North Dakota	8,255	3.4	8,214	-0.5	8,477	3.2	8,943	5.5
Oklahoma	40,381	3.2	40,179	-0.5	41,585	3.5	44,247	6.4
Oregon	33,921	5.5	35,590	4.9	37,430	5.2	39,410	5.3
Utah	17,259	6.1	18,036	4.5	19,208	6.5	20,668	7.6
Washington	61,185	5.7	64,244	5.0	67,456	5.0	70,964	5.2
Wisconsin	62,815	4.7	65,328	4.0	69,378	6.2	74,928	8.0
Wyoming	6,734	5.1	6,869	2.0	7,075	3.0	7,428	5.0
First Interstate Territory	921,169	6.8	968,365	5.1	1,034,062	6.8	1,117,972	8.1
U.S.	3,310,545	6.7	3,495,936	5.6	3,740,651	7.0	4,062,347	8.6

Note: All calculations based on unrounded data.

For these states to boom again, oil and agricultural markets would have to revert to conditions of the 1970s, which is unlikely.

The outlook for the FI Territory states over the next two years is as widely divergent as was their experience during 1985 and 1986. The last graph depicts this divergence in employment growth, showing the three expected high-growth states within the Territory and the three expected slowest performers. The bottom three, Alaska, Wyoming, and North Dakota, all have economies significantly dependent on oil. Wyoming and North Dakota also have important agricultural sectors. Both these sectors have been hard-hit in the last two years, and little improvement is expected within our forecast horizon. Lower oil prices have been a mixed blessing to farmers in North Dakota and Wyoming, as they have resulted in lower production costs but also have lowered farmers' income by reducing their royalty payments.

The two major agricultural commodities in Montana and North Dakota are wheat and cattle. Low prices have significantly weakened farmers in these two states; large surpluses of wheat are likely to continue through 1987 and 1988, with further downward pressure on prices.

The three top performing states are forecast to be Nevada, Arizona, and Utah. Arizona and Utah are both well-diversified economies with high-tech-oriented manufacturing bases and strong service and trade sectors. Recent declines in Arizona semiconductor employment have been more than

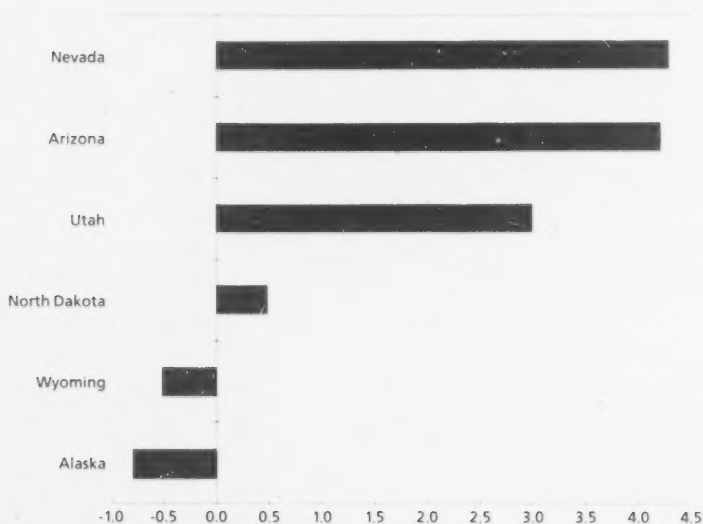
offset by strong gains in the aerospace sector. Utah's high-tech manufacturing base is not quite as well diversified as Arizona's and has experienced slower growth recently. The outlook for a rebound in the computer and semiconductor industries in 1987 bodes well for both Arizona and Utah.

The Nevada economy has experienced only one year of declining growth in the last thirty years, and that was in 1982 as a result of the national recession. Since then, Nevada has regained its place as one of the fastest growing states in the country. Atlantic City appears to have had only a short-term impact on tourist traffic from the East to Nevada. The state's average annual employment growth over the past 25 years has been 6%. We expect a 4.2% average annual rate of growth during 1987 and 1988. Nevada's dependence on tourism, with the service and trade sectors representing almost 65% of the state's employment base, has not had as significant an impact on its economic growth as has occurred in many other single-industry-dependent states. Nevada's continued efforts to diversify its economy can only improve prospects for the state.

The next two years will be a slow growth or stabilization period for many states within First Interstate Territory, particularly those which have been dependent on the energy and/or agricultural sectors, as mentioned above. Others, including Hawaii, Washington, Indiana, and Wisconsin, will experience an improvement over their problems of the early 1980s, but will not exceed the national average in growth. Overall, however, the

Territory will experience rates of growth only slightly below the national average.

Employment Growth Diverges Widely in FI Territory
(Annual employment growth, 1987-88)





Cyclically dependent and import-sensitive U.S. industries have been laboring through the first half of the 1980s to restructure and improve competitiveness under the pressures of a strong dollar and sluggish growth. Companies that have risked

investment in reorganization and automation will be rewarded by the faster economic growth and more favorable terms of trade that we see in the next two years. The more favorable economic environment, however, will not be sufficient to rescue troubled firms in industries suffering from fundamental structural deficiencies.

Manufacturing—Industries to Perk Up

Our outlook for growth of production over the next two years for selected leading industries appears in the accompanying chart. Just as last year, aerospace ranks first.

Despite slower growth of the defense budget, there is still considerable carry-over momentum for spending. On the commercial side, stronger growth of air passenger traffic stimulated by a faster pace of economic growth should support demand for new aircraft. Continued restructuring of airline fleets to improve both aircraft efficiency and traffic management should also add to demand.

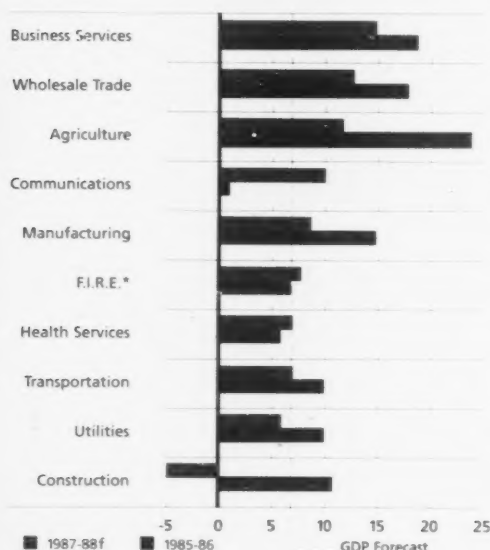
Growth of aircraft production increased noticeably over the last year. Continuation of this trend would cause actual output to exceed our forecast, but we are allowing for some slowdown in growth of defense spending and some easing of air transport demand in 1988.

We expect publishing to continue its strong growth, as demand for advertising picks up with a more active economy. Magazines should benefit from a continuing trend of advertisers seeking to focus more accurately on target markets.

Machinery consists of non-electrical, which includes computers, and electrical, which contains semiconductors and electrical appliances. These industries will be focal points of the capital investment and consumer-durables spending that we foresee. They will benefit from the delayed adjustment of trade patterns to the dollar's fall as well as from its further decline.

Trade and Services Top Real Output Growth

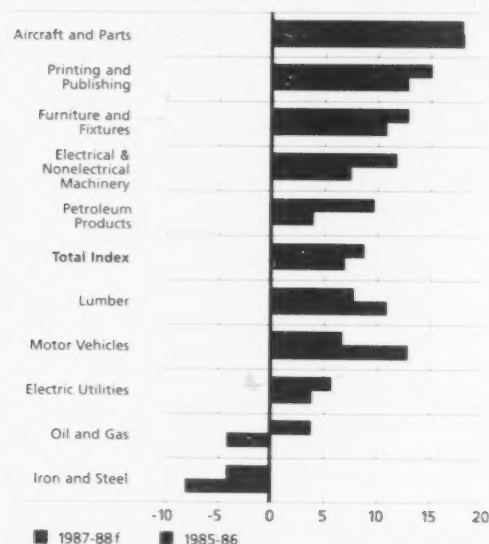
(Two-year percent increase in gross domestic product)



*Finance, Insurance and Real Estate

Growth in Manufacturing Output—Leaders & Laggards

(Two-year percent increase in industrial production indexes)



New Construction Spending

	Residential \$ billions	% Annual Change	Industrial \$ billions	% Annual Change	Commercial \$ billions	% Annual Change	Public \$ billions	% Annual Change
1983	136.6	45.8	12.9	-25.4	36.0	-4.0	54.6	0.7
1984	164.0	20.1	13.8	7.0	48.3	34.2	58.9	7.9
1985	171.1	4.3	15.8	14.5	59.8	23.8	67.3	14.3
1986e	185.3	8.3	15.1	-4.7	56.4	-5.6	69.4	3.2
1987f	181.9	-1.9	13.7	-9.0	48.0	-15.1	70.5	1.5
1988f	184.6	1.5	14.6	6.6	51.1	6.6	74.8	6.1

Sales of computers and telecommunications equipment should respond well to faster growth of corporate profits and the reduction of impediments from technical factors that have dampened demand over the past two years. We expect the more robust economy to pull the high technology industry out of this recent slump. The surviving companies, however, will continue to be under pressure to reduce costs and improve marketing and product mixes.

Production of petroleum products will grow significantly faster than over the past two years. Refinery output sped up sharply in the first half of 1986 along with the large drop of crude oil and product prices.

With crude prices likely to remain in the mid-teens, industrial users who have switched to oil are likely to stay with it, and transportation demand is likely to remain stronger because of lower fuel prices. Added to the effect of lower prices on demand will be faster economic growth. With crude

prices in this range, refinery margins should be adequate to keep product prices from rising enough to choke off demand.

Industries that we expect to underperform the overall production index over the next two years are also shown on the chart. Growth of lumber output will slow because of lower new residential construction. The dollar's drop will not help stave off competition from Canadian imports, because the Canadian dollar has fallen in step with the U.S. currency.

Production of domestic auto makes will grow more slowly because manufacturers' financing incentives and expected loss of tax benefits this year have borrowed sales from future years. Imports will continue to capture market share from domestic models, as domestic price increases offset some of the benefit of the lower dollar. Increased manufacturing of foreign auto makes in the United States will boost measured domestic output growth.

The lower dollar and the import restraint program should help to slow the slide of the domestic steel industry, but continued import penetration will prevent a turnaround in this sector in the forecast period.

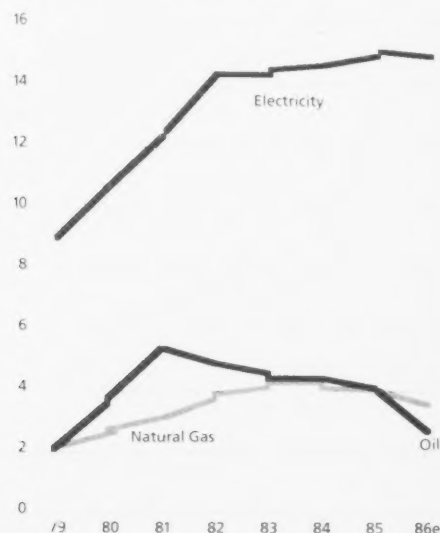
Mining—Oil Recovery Slow but Gas Use Could Rise

Within the broad category of mining, our analysis focuses on oil and gas extraction. Although these sectors share common technology and produce energy, the outlook for U.S. oil production is being determined by geopolitical factors, whereas the future of the gas industry depends heavily on developments in the domestic regulatory arena.

Economic pressures are likely to force OPEC to maintain some kind of control on output that could leave prices fluctuating in the mid-teens for some time. Saudi Arabia is unlikely to limit its own production enough to get prices back into the mid-to-high 20s, and OPEC is unlikely to revert to a strategy of

Energy Prices Change Direction

(Dollars per mm btu, annual averages)



unrestrained output that would drive prices down into single digits. These factors are evident in the recent tenuous agreements to limit OPEC production. Despite the appearance of increased stability of oil prices inherent in this scenario, a substantial risk of destabilization is presented by the potential for an intense escalation of the Iran-Iraq conflict by the spring of 1987.

U.S. drilling activity has recovered somewhat from its low point, as some enterprises are betting on increasing crude prices. It is not so much the level of prices that determines the viability of projects as their relative stability. Notwithstanding the explosive potential of Middle East politics, if stable prices tend to lead to expansion of non-OPEC sources, the threat to OPEC's market share could again precipitate destabilizing events.

Regulatory and institutional barriers have for many years inhibited production and distribution of natural gas in the United States. These include wellhead price controls on "old" gas and pipelines' reluctance to transport gas for third parties. Because of lower oil prices, industrial users are switching off gas networks and forcing utilities to try to shift rate burdens to residential users.

The Federal Energy Regulatory Commission is attempting to offset this trend by increasing the flexibility of gas markets through rulings that encourage third-party transportation and price flexibility through renegotiation of contracts. If regulatory initiatives are unsuccessful in increasing gas flows, then full deregulation of the industry

is likely to occur in 1987. Either way, gas production is likely to increase substantially in the next few years.

Agriculture—Crisis Looms from Ballooning Subsidies

Spurred by federal subsidy programs and tax preferences, the farm sector's growth of real output over 1984 and 1985 was a record for any two-year period since the mid 1960s. Acreage reduction incentives in the 1985 farm bill have led to some moderate reduction of grain output in 1986 relative to 1985's fifteen-year record.

Growth of real farm output over the next two years should be slower because of continued government programs to rein in crop production and an end to tax incentives for cattle feeding. The ballooning proportions of federal farm outlays may generate a crisis atmosphere that could result in much more direct government control of grain production. If that occurs, growth of farm output could be less than shown in the graph.

Farm prices have firmed somewhat, but prices of some supported crops have plunged in response to overproduction. Real-estate values have continued their declining trend in 1986. Employment should continue to shrink at about the same rate over the forecast period as in the 1984-85 interval, as continued financial distress of some farmers and the end of tax preferences induce further exit from the industry.

Medium-sized family farms in the Upper Midwest producing grain or livestock are the most financially vulnerable group. The over-

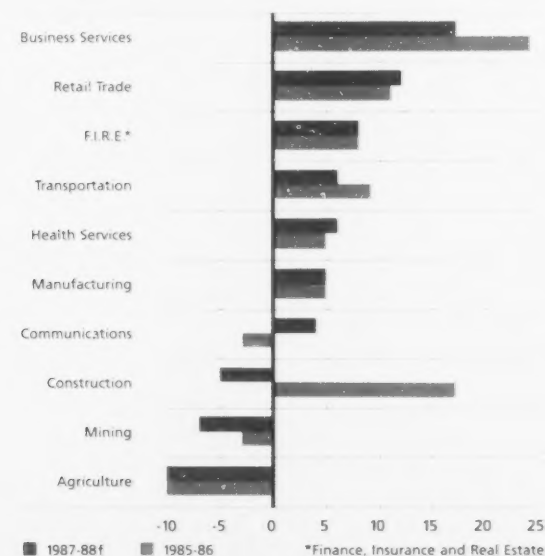
all financial condition of distressed farms has not worsened significantly, however, but full recovery of the sector is not in sight within the forecast period.

The 1985 farm bill has clearly failed to solve the problem of mounting surpluses of subsidized grain crops. Although the government's offered prices were lowered, they still remain above world market prices for wheat, corn, and soybeans. Thus exports have failed to provide hoped-for relief. Depreciation of the dollar has not improved the terms of trade for most U.S. grains, because the currency has not fallen relative to those of other grain exporters. International competition is intense because of growing world production capacity and financial problems of grain importers. High rates of participation in the subsidy programs, encouraged by the structure of the legislation, and higher unit subsidies have led to record farm outlays estimated in excess of \$25 billion for the 1986 fiscal year just ended, compared to less than \$18 billion in the prior fiscal year.

Cotton and rice exports have increased substantially this year because the 1985 bill facilitated their sales to the world market at competitive prices, whereas for other major crops such sales were inhibited by limits on unit subsidies. Proposals have been advanced in Congress to extend the more liberal treatment to these other major crops. Passage would add about 5% to the cost of the subsidy programs, so there is resistance to this approach because of broader fiscal difficulties.

Service Job Growth Buoyant but Key Goods Sectors to Shrink

(Two-year percent increase in employment)



Communications—Competition Heats Up

Telecommunications revenues are expected to receive a boost from increased business activity in the next two years. Revenue growth will be moderated by price cutting in the wake of intensified competition in the long-distance market, however. Long-distance carriers are entering a period of aggressive price competition, now that customers have "equal access" to local telephone networks and telephone rates have been restructured to eliminate subsidies to local services. At the local level, the growth in the number of industrial customers opting to bypass local telephone companies by building private communications networks also threatens to erode industry revenues.

Deregulation at the state level has already begun to address this threat and should accelerate as more states recognize the potential for bypass undermining the financial viability of local phone companies. As a result, rates will be more closely related to costs, and local rates should rise relative to long-distance. At the federal level, the expected shift of jurisdiction over the telephone industry from the courts to the Federal Communications Commission should result in a relaxation of the present restraints on local operating companies from entering related equipment and services businesses, thus intensifying competition in these areas.

Television networks can expect to see an improvement in advertising revenues during the cyclical upswing that we are forecasting. The quicker pace of GNP growth and corpo-

rate profits should lead to increased corporate advertising budgets, and advertisers should be willing to reallocate some of their budgets back toward more traditional television advertising. The longer-term trend of alternative television media, such as cable and VCRs, to erode the networks' share of TV viewing should continue, however.

The financial performance of the cable-TV industry is expected to remain healthy, although revenue and profit growth will moderate relative to the remarkable growth rates in the previous five years. As in the broadcast industry, cable advertising revenues should expand with the economic pickup we are forecasting, but nonsubscription revenues will remain a small share of overall cable revenues. The industry must turn to the task of generating more subscribers, now that a large share of television households are wired for cable. Progress will be slow, however, considering the difficulties involved in improving cable programming and creating new cable services to compete with other media, especially VCRs.

Insurance—Higher Rates Improve Stability

Our forecast of an upturn in the U.S. economy and moderate increases in interest rates should improve the stability and financial performance of the property-and-casualty insurance industry. Steep increases in insurance rates, now set at more actuarially sound levels following big pre-tax operating losses in the industry, should boost premium receipts. With prudent investment strategies,

sound actuarial principles, and control of expenses, the industry should be able to realign its pricing structure and improve its profitability.

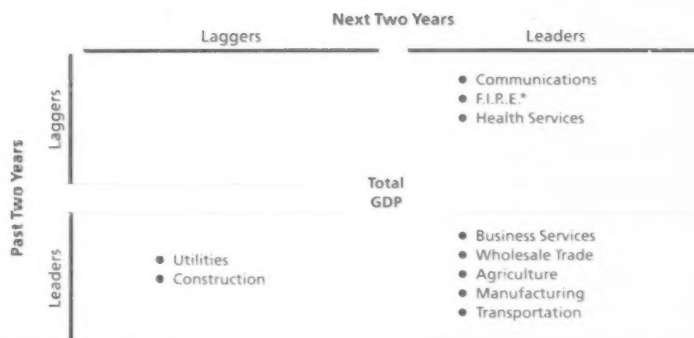
The life-and-health insurance industry will benefit from the real economic growth in our forecast. In addition, lower personal tax rates should help to stimulate demand for life insurance by increasing disposable income and enhancing savings incentives. A proposal to tax savings accumulated in life insurance policies in the recent tax reform package was defeated. Companies will still have to contend with the tendency toward a lower growth rate of premium receipts, however, as the shift to universal from regular whole-life insurance policies continues.

Health Care—Squeezed by Cost Controls

Although health-care providers may benefit from the employment gains that we forecast in the next two years if the number of employees covered by health insurance also rises, the industry will continue to struggle under increasingly competitive conditions. Hospitals have been hurt by the rising share of empty hospital beds, reflecting cost-cutting measures by insurers that encourage shorter hospital stays and a shift to outpatient treatment. Hospitals and physicians face intensified competition from alternative health-care services, especially health maintenance organizations (HMOs).

Rapid growth in HMOs is likely to lead to fierce price competition among the managed health plans. Pressure to cut costs

Industries in Transition



*Finance, Insurance and Real Estate

could jeopardize the quality of medical services offered by this segment, however. HMOs have already come under criticism for achieving lower costs, estimated at 25% below conventional health-care costs, through compromising on proper medical care.

The possibility of a major price war erupting in the industry will put pressure on both hospitals and managed health plans to continue to focus on cost containment and could threaten profits in the industry. Recent reorganizations among the largest hospital chains may signal further consolidation in the health-care industry.

Transportation—Rates to Firm with Pickup in Traffic

We expect the recent wave of airline mergers to bring an end to the fare wars that

contributed to big losses in the industry this year. In addition to a firming in ticket prices, the airlines will benefit from continued moderation in fuel costs in the forecast period. The expected increase in economic growth should boost business travel and shift the airline passenger mix more toward full-fare travelers. Growth in after-tax income is expected to raise consumer spending on air travel as well. Airline stocks have already begun to rise in anticipation of improved revenues. The consolidation under way may promote greater efficiency among the surviving airlines and improve the financial health of the industry.

Freight shipments should rise with the expected step-up in business activity. The preference for trucks will continue because they offer greater flexibility and speed compared to shipment by rail. Our projections

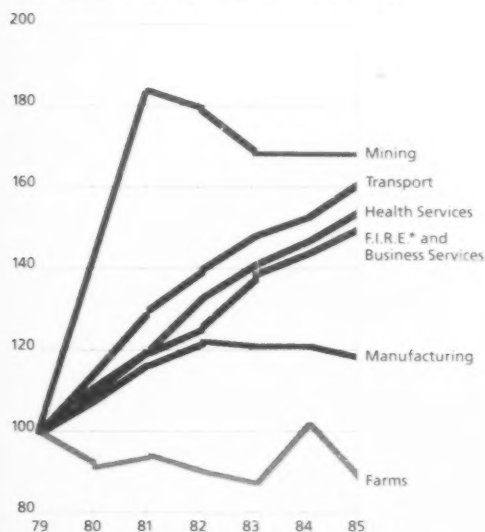
for faster growth in the production of high-valued manufactured goods, relative to heavy, bulky products, will also contribute to the demand for shipping by truck. Several railroads have adapted to competition from alternative carriers by merging with trucking and ocean-shipping companies to expand the range of services they can provide. Although railroads account for a shrinking share of total U.S. freight transportation, the industry faces a more profitable future because of moderation in fuel costs and some progress in productivity gains.

Electric Utilities—Cash Flow Rises as Construction Winds Down

Electricity usage is expected to grow at annual rates of about 3% over the next decade. Electricity sales are likely over time to become less sensitive to fluctuations in heavy industry, reflecting the ongoing transition from industrial production to services in the U.S. economy. In the near-term, electricity usage will be dampened by slow growth in the most electricity-intensive industries and by increased reliance on cogeneration among large industrial users, who may find it more economical to produce their own electricity. The financial health of the industry as a whole is expected to continue to improve because construction spending is scheduled to wind down and fuel costs and interest rates are expected to remain moderate.

Divergence of Inflation and Deflation

(Price Indexes: gross product deflators, 1979 = 100)



*Finance, Insurance and Real Estate

One of the major factors that will restructure credit and debt markets in 1987 and 1988 is financial deregulation, either de facto or legislative. Continuation of securitization also will tend to encourage new debt expansion. The changing tax structure will

shift incentives from certain forms of credit expansion to others as deductions become more limited. The fears that the increasing burden of debt on the economy will cause excessive strain on the financial system are most likely overstated, as the system has proven to be quite resilient. Loan quality will remain a very serious concern facing the financial industry, especially as the economy has faltered in the areas of energy, agriculture, mining, and commercial real estate.

U.S. Credit Markets Grow Rapidly

The pattern of borrowing and lending in the United States has undergone tremendous change over the past few years. Demand for credit has been unusually strong, even when taking into consideration the fact that the economy has been expanding for nearly four years. The demand for funds picks up in a growing economy as private borrowing strengthens, although it usually keeps pace with the growth in nominal gross national product. Since 1981 the growth of accumulated debt has substantially exceeded the rate of domestic output. Continuation of this trend over an extended period would have significant implications for the U.S. economy and the financial structure.

Total domestic nonfinancial debt in the U.S. expanded by a substantial 14% in 1985, reaching an outstanding level of nearly \$7 trillion. This is the third consecutive year that this measure of debt has grown at double-digit rates. It is important to note that such growth of debt occurred within a disinflationary environment, which should have had a dampening effect on debt accumulation. The rapid acceleration of debt was for the most part triggered by the federal government's heavy reliance on debt financing during the last recession, when the growth rate of government borrowing reached a peak of 19% in 1982. Although the rate of growth of U.S. government debt has decelerated somewhat since 1982, the growth of private borrowing has picked up dramatically through 1985. Latest available data indicate that total debt accumulation moderated

in the first half of 1986.

Households comprise a large portion of total debt (34%), most of which resides in holdings of home mortgages. Growth of both consumer mortgages and consumer credit showed marked increases from the lean years of the last recession. Growth of household debt (14% in 1985) has exceeded the growth of personal disposable income since 1981. There has been abundant concern about the ability of households to maintain this level of debt, especially if recessionary conditions were to emerge. One warning indicator usually cited about the financial strength of the consumer is that of the decline in the saving rate from 7.5% in 1981 to below 5% in 1986. This rate, however, does not reflect changes in overall wealth since it excludes holdings of real estate and capital gains in financial assets. We do not expect consumers to find it particularly difficult to meet their monthly payments, although we do expect the rate of consumer credit expansion to decelerate.

State and local government debt has been growing quite rapidly since 1983, despite rising surpluses in state and local budgets. The massive surge in borrowing during 1985 was due to anticipation of pending legislation that restricted the use of housing bonds, advanced refundings, and arbitrage. Although this sector is the smallest user of total domestic nonfinancial debt, it grew by \$108 billion to over \$492 billion in 1985, dramatizing the implications of changes in policy on debt markets.

The other important component of total

Short-Term Business Credit Demand

(Change over prior year, billions of \$)

	C&I Loans All Large Banks		Non-Financial Commercial Paper	
	Amount	Percent	Amount	Percent
1980	\$17.7	11.6%	\$5.6	19.7%
1981	22.3	13.1	15.3	45.0
1982	19.8	10.2	-6.1	-12.4
1983	6.7	3.2	-0.7	-1.6
1984	28.3	12.9	22.6	53.2
1985	5.5	2.2	15.2	23.4
1986 (First half)	7.3	2.9	3.6	4.7

debt is nonfinancial businesses. Business borrowing, which also makes up just over 34% of total debt, has shown large increases in long-term debt, while short-term debt grew relatively slowly. Nonfinancial-business debt grew by only 11% in 1985, most of which was long term (14%), as companies have been restructuring their balance sheets to lock in lower interest rates. Short-term business credit growth was the slowest growing sector of all in 1985 at only 6%. Much of the increase in long-term business borrowing over the past couple of years is a result of the large equity retirements that have been brought on by the record number of mergers, acquisitions, and leveraged buy-outs. The accompanying graph, showing the sources of long-term business capital, depicts the sharp drop in holdings of equity since 1983 as it has been bought back and retired. Part of this has been a result of different incentives in the tax codes; it has been

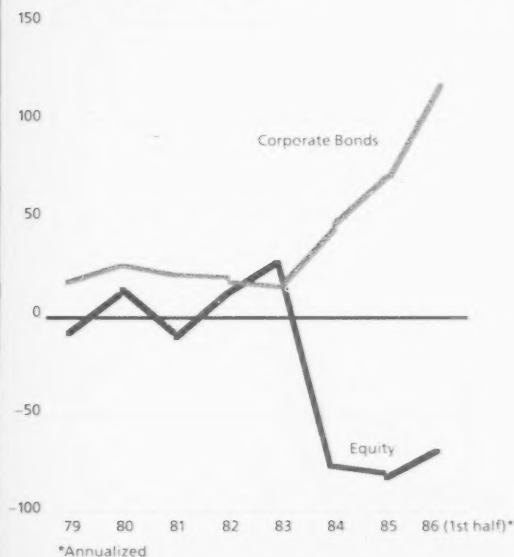
more profitable to hold debt than equity, with dividends double-taxed and interest tax deductible. This trend may be reversed over the next few years in response to tax reform legislation. Corporations have utilized the bond market more since 1983, when interest rates began their cyclical decline.

The financing gap is a measurement of the borrowing needs of corporations. As the accompanying graph indicates, internal funds have exceeded capital expenditures in 1985 and in the first half of 1986. This is significant because nonfinancial businesses borrowed substantially more than needed for financing operations and capital investment. The majority of the borrowing was actually used to retire large volumes of equity over the past two and a half years.

The accompanying table shows the recent growth pattern of the two components of nonfinancial corporate short-term debt: commercial and industrial loans and nonfi-

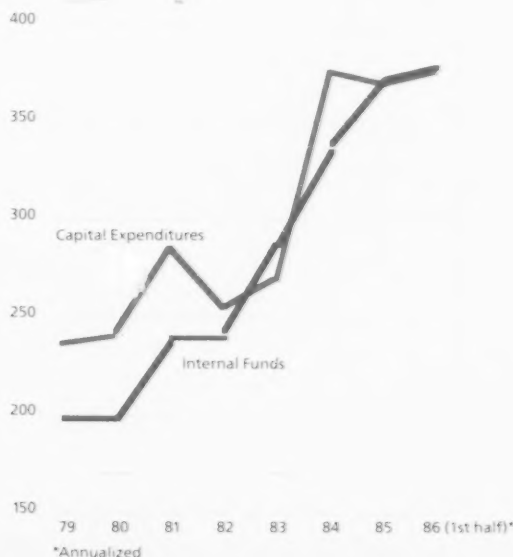
Long-Term Business Capital— A Continuing Divergence

(Net change in billions of dollars)



Corporate Financing Gap Virtually Closed

(Billions of dollars)



financial commercial paper. During the inflationary early 1980s, corporations had an incentive to rely more heavily on short-term borrowing, given high interest rates. With the decline in interest rates, this situation has reversed. The table indicates the slowdown that we have observed in both loans and paper. Nonfinancial commercial paper, however, has been more consistently utilized over the past few years than bank loans. This is one indication of the trend of corporations bypassing commercial banks and going directly to the open market for their credit needs.

Credit Quality Becoming a Greater Concern

A major concern about the rapid acceleration of outstanding debt is that it has brought about a significant deterioration of the overall quality of debt and that it poses a threat to the stability of the financial system. As credit markets are being liberalized and more options are open to both investors and savers, nonperforming bank loans have been mounting, junk bonds have proliferated, and there has been an increasing incidence of defaults on these and other corporate bonds. A significant number of corporations have been downgraded by the major credit-rating services. Those firms maintaining high ratings issue their own debt, leaving financial institutions to finance the remainder, which may contain a higher element of risk.

Securitization Is Reshaping Risk

Securitization is currently one of the major developments in the financial world. It

involves issuing securities that are backed by mortgages, auto loans, credit-card debt, accounts receivable, or any other financial asset with a predictable and measurable payment stream. Usually, a financial institution will originate assets through loans, package these loans, and sell them as securities, with ownership of the package transferring to the investor. Companies in other industries are not precluded from securitizing, but financial institutions would seem to possess a comparative advantage in this area. The major advantages of securitization for financial institutions are enhanced asset/liability management, improved liquidity, lower cost of funds, more efficient intermediation, and greater diversification of loan portfolios.

Perhaps the most important consequence of securitization is the competition it will produce between banks and nonbanks to allocate credit. Increased competition for assets should result in lower borrowing costs. With costs falling to lower levels than otherwise, companies are bypassing banks completely and selling directly to investors. Eventually, banks may operate like stock brokerages, warehousing loans that will ultimately be sold to investors. A negative aspect, however, of increased competition and separation of lender and borrower may be less careful credit evaluations.

The major policy question is how effective monetary policy will be with increased disintermediation from securitization. As financial institutions become less responsible for the creation of loans, monetary policy may have

to work through different means. The other major policy questions are: (1) Should funds received from securitized assets sold with recourse be considered deposits and thus included in reserve requirements? and (2) If a bank sells securitized assets with recourse, should the bank hold capital against the assets, since total riskiness of the bank's loans remains unchanged? The outlook for growth in securitization is good, although policy changes could dampen financial institutions' incentives to securitize. In the future, many different types of assets will be securitized, although the easiest frontier, mortgages, has already been developed.

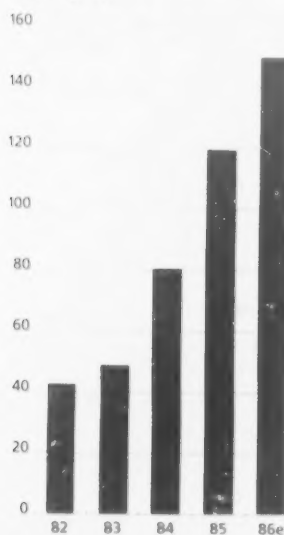
Financial Institutions Cope with Change

Several powerful forces are at work that will change the financial industry in the years ahead. These include intense competition from within and outside the traditional industry; structural changes brought about by deregulation; an extremely high incidence of mergers, acquisitions, and failures; and new technology. The expansion of interstate banking and regional compacts, capital requirements, innovative new products, debt problems, and omnibus banking legislation are all concerns of market observers and participants.

The financial industry shows a high degree of disparity among its members, with many institutions extremely strong and profitable and others foundering, even failing, at record rates. As the chart illustrates, 120 commercial banks failed in 1985, which was the highest number to fail since the Great

Bank Failures on the Rise

(Number of bank failures per year)



Depression. Through September of 1986, 109 banks failed, and we expect the number for the year to total about 150 failures, another new high. The savings and loan industry had 57 closings or mergers assisted by the Federal Savings and Loan Insurance Corporation (FSLIC) last year and 52 through the middle of August this year. These failures have opened up opportunities for interstate acquisitions as the Federal Deposit Insurance Corporation (FDIC) and FSLIC attempt to find healthy institutions to acquire those that are failing, in order to avoid costly payoffs of insured deposits.

The industry is currently in a state of transition, testing the waters of new markets along with the increased challenges from competition. Competition increases market efficiency and is beneficial to consumers. However, institutions that had for years existed in a highly regulated environment are experiencing a shake-out of those unable to adapt to these pressures and challenges. Intensification of competition has also eroded profit margins of many financial intermediaries, as more information from more suppliers has caused consumers to become more price sensitive.

Regional Legislation Proliferates

Disparity within the financial industry is depicted on the accompanying map, which indicates the legislative progress that has been made on a state-by-state basis in recent years. By experimenting with regional compacts, states will be able to decide whether there is any loss of attention to

local economies or any threat of concentration of financial resources. As can be seen from the accompanying map, 26 states have enacted legislation on interstate banking that would enable their banks and savings and loan associations to be acquired by out-of-state institutions. In addition, several other states have passed laws allowing interstate acquisitions of their troubled institutions and permitting limited banking functions by out-of-state banks. Regional compacts have been the most common type of agreement reached in the last two years, with the majority of these containing provisions for reciprocity (the requirement that states with banks entering the home-state allow entry of home-state banks on the same terms). The Southeast and the West are examples of regional banking zones. California was the most recent state to open its borders under a regional compact containing a reciprocity provision as well as a national "trigger," a provision that specifies an amount of time that must pass or a sequence of events that must occur in order for national entry to become a reality.

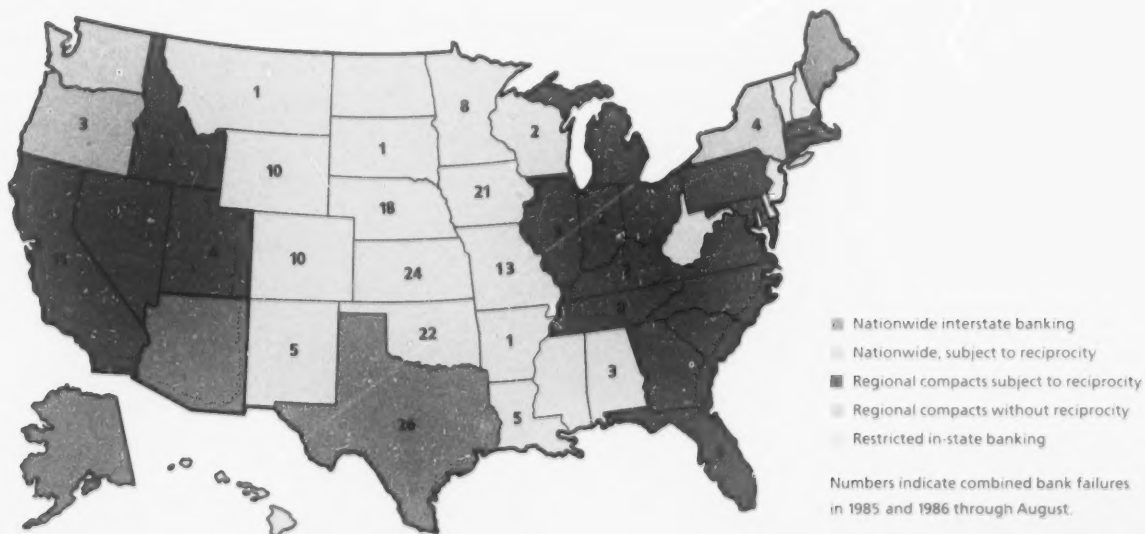
Far less common are states permitting full interstate banking, with or without reciprocity requirements. Alaska, Arizona, Maine, New York, and, as of this year, Texas are the only five states that fall into this category. It is significant that states that have not passed legislation allowing interstate banking, most notably those in the Midwest (mainly agricultural and energy states), have not been able to keep their boundaries completely closed. As this region has accounted for a

disproportionate share of U.S. bank failures in recent years, purchases and mergers by out-of-state institutions have been made possible. Acquisitions have been made attractive as the FDIC and FSLIC have offered buyers the right to enter a new market at a low cost, often with financial assistance from the federal government.

As more states draft and approve interstate banking legislation, the pressure to do the same in the remaining states increases. It appears probable that most new legislation will be regional in nature and contain phase-in provisions designating a year in which states will open fully for nationwide banking. No omnibus federal legislation on the issue is expected to be approved during our 1987-88 forecast horizon.

Loan quality will remain a serious concern facing the financial industry, especially in the areas of energy, agriculture, mining, commercial real estate, and Third World countries. We expect only modest improvement on agricultural loans, as this is a long-term problem. Energy and mining loans should improve somewhat with the expected firming in oil and other commodity prices. Commercial real-estate loan quality will continue to be troublesome over the next year, but should show improvement by 1988. As the economy strengthens and loan-quality problems diminish, we should see some leveling off of the number of failures of financial institutions in 1987 and 1988. Nevertheless, we expect to see a continuation of the trend of concentration within the financial industry in the years ahead.

Fewer Barriers to Interstate Banking





During the coming two years, the international economy will be characterized by somewhat more rapid growth in the industrial countries, a faster rise in world trade, some increase in commodity prices, and further capital-market innovations.

These factors will in

turn enable many developing countries to continue to improve their financial positions. Major disparities will persist, however, including that between the U.S. current-account deficit and the surpluses of Japan and Germany, causing trade friction. The disparity between the newly industrialized countries and developing countries that export commodities will also be important, with new approaches to the debt problem likely to result from the difficulties of the latter group.

Current-Account Disparity Threatens Industrial-Country Growth

Industrial economies benefited from several economic developments in 1986. Lower oil prices, a reduction in inflation and interest rates, a lower dollar, and decreases in government budget deficits, except in the United States, have improved the prospects for balanced non-inflationary growth during 1987-88. However, the large current-account disparity between the United States and two of its trading partners, Germany and Japan, is still a threat to balanced growth.

This imbalance continues to be enormous, despite the depreciation of the dollar by over 40% against the Deutschmark and the yen, and contributed to U.S. demands for faster growth in Japan and Germany, aimed at easing the trade imbalance. Japan responded by introducing a mini-package of government spending. In Germany, however, where the economic situation has improved, authorities do not appear willing to stimulate further their economy, despite 8-9% unemployment. The "locomotive" of international cooperation appears to have slowed.

In view of this flagging cooperation, the United States has threatened to allow the dollar to fall further. A slide of the dollar would imply lower growth in the exports of other countries, particularly Japan. More importantly, a drop in the dollar's value could trigger a rise in U.S. inflationary expectations and interest rates, undercutting economic growth here and abroad.

Our economic forecast for the seven major industrial economies, as shown in the

Industrial-Country Economic Indicators

	Real GNP (% change)			Inflation (%)			Current Account (\$ B)		
	1986e	1987f	1988f	1986e	1987f	1988f	1986e	1987f	1988f
Japan	2.4	2.8	3.0	1.5	2.5	3.8	74.8	70.0	62.0
Germany	3.0	3.5	2.5	0.7	1.3	2.5	27.5	19.5	19.0
France*	2.3	2.5	2.2	3.6	4.2	4.2	5.5	3.5	4.0
United Kingdom*	2.8	3.2	2.6	3.4	3.9	4.5	2.5	0.5	-1.0
Italy*	3.0	3.0	2.2	6.5	6.0	5.8	-0.3	1.2	3.8
Canada	3.5	3.6	3.1	4.0	4.2	4.6	-3.8	-2.2	-1.8
Above plus USA	2.7	3.1	3.2	2.4	3.5	4.4	-34	-54.0	-52.0
Total OECD	2.7	3.0	3.0	3.3	4.1	4.8	-25	-49.0	-48.0
OECD - USA	2.7	2.9	2.5	4.1	4.4	4.8	115	97.5	90.0

*GDP

accompanying table, calls for collective real growth of 3.1% in 1987 and 3.2% in 1988, compared with an estimated 2.7% this year. We expect economic growth in most of the industrial economies to slow somewhat in 1988 as interest rates rise and the favorable effects of lower oil prices diminish. Inflation should pick up moderately over the next two years, particularly in the United States, the United Kingdom, and Canada. Further lowering of government budget deficits is anticipated. However, the industrial countries' collective current-account deficit is forecast to average higher over the next two years due primarily to a larger U.S. deficit. As the graph indicates, the disparity between the U.S. deficit and the Japanese and German surpluses is expected to remain wide during 1987-88. Trade friction among these countries is unlikely to diminish.

World Trade Growth to Increase

World trade is a major mechanism by which real economic growth in the industrial countries is transmitted to the developing world. As the expansion from the 1981-82 recession has continued, world trade in volume terms has increased, as the table below shows. Our forecast indicates growth in the volume (adjusted for price changes) of world imports will rise during each year of the 1986-88 period. Differences in the yearly volume growth rates largely reflect changes in industrial-country real economic growth, as the graph illustrates.

World Trade

(Imports, percent change)

	1984	1985	1986e	1987f	1988f
Volume	9.0	4.2	3.7	4.4	4.7
Nominal	6.4	1.8	3.2	7.6	8.5

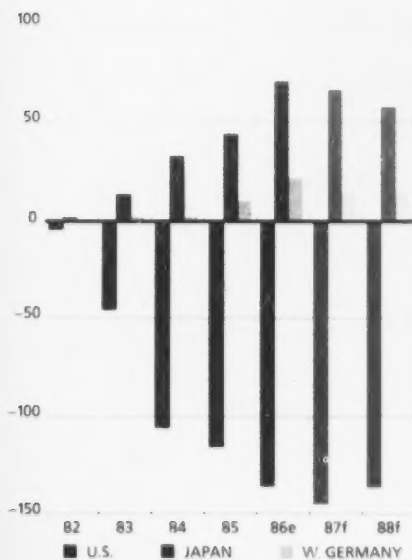
Not all countries benefit equally from world-trade growth, as shown by comparing real and nominal growth rates. In every year since 1980, the real volume of world trade has grown more rapidly or declined less than world trade on a nominal basis, reflecting falling import prices.

In 1985, for example, non-energy commodity prices collapsed, and the countries supplying these goods suffered as output could not be increased sufficiently to compensate for declines in prices. In early 1986, energy prices fell, and most energy-exporting countries were worse off.

The beneficiaries have been those economies that import commodities—mainly the industrial economies and the so-called NICs, the newly industrialized countries like South Korea, Taiwan, and Brazil. Thus, the position of these countries has been reversed from

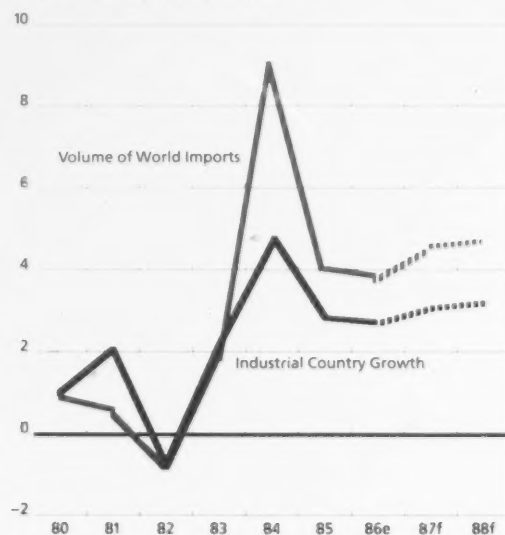
Current-Account Imbalances Persist

(Billions of U.S. Dollars)



Growth in Volume of World Trade Reflects Real Economic Growth in Industrial Countries

(Percent change from year ago)



that during 1974-81, when commodity prices rose rapidly.

New Approaches to Developing-Country Debt?

Lower interest rates and expanding world trade are favorable for the developing countries. Considerable disparities exist in the outlook for these countries, however, depending on whether they rely on the export of primary commodities—including oil—or on manufactured goods.

Countries that export manufactures (the NICs) now have a powerful combination of factors—lower interest rates, lower oil prices, and strong growth in U.S. final demand—improving their growth and financial prospects. In addition, their currencies have generally depreciated against the U.S. dollar as the yen and the major European currencies have appreciated. As a result, their export competitiveness has increased, both in the United States and elsewhere. The largest NICs, including Brazil, Taiwan, and South Korea, are now recording current-account surpluses, allowing them to improve their external financial positions. Brazil can do without “new money,” while Taiwan is building up its international investment position. Economic growth in the NICs is back to very high levels.

In contrast to the much improved position of the NICs, countries exporting commodities, especially oil, face continued difficulties. Overall, we do not expect commodity prices to increase much above the general level of inflation during 1987-88, implying no

improvement in the terms of trade of these countries. Efforts to diversify away from primary commodities are under way but will take time.

The strategy for handling the debt problems of developing countries has involved annual rescheduling and “new money” exercises, usually with IMF-supported adjustment programs. Since this strategy has been in effect, there have been a number of advances in the overall situation: the improved maturity structure of the debt, the large trade surpluses recorded by some debtor countries, better political situations (e.g., Argentina, Brazil, and the Philippines), and important reforms in economic policies.

Despite these improvements, the magnitude of the debt problem has worsened. As illustrated in the graph, the ratio of external debt to exports for the fifteen countries originally in the Baker Plan has risen since the advent of the debt crisis because of the continuous infusion of new money when exports were growing very little. Thus, the strategy followed has not produced a fundamental improvement.

During the coming two years, alternative strategies are likely to be applied. These could involve (1) capital-markets techniques, including securitization and debt-to-equity swaps, (2) payment-in-kind schemes, and (3) interest-rate relief. Ideally, no single way of dealing with the debt problem will be applied by all banks or in all countries.

Some of the above alternatives—especially interest-rate relief—could involve income losses for banks. However, the perception

that banks are not increasing their assets in certain countries could be favorable to shareholders. In the developing countries, these strategies would minimize the increase in debt, giving them a better chance of growing out of the problem.

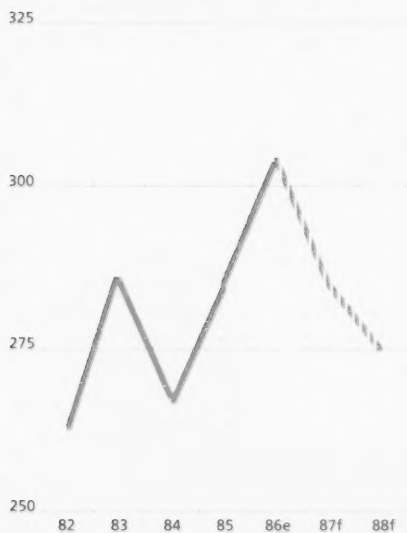
U.S. Dollar Declines, but...

The depreciation of the trade-weighted U.S. dollar as calculated by the Federal Reserve is well known but misleading, especially as to its effect on the U.S. trade deficit. The Fed's dollar index is a basket of ten currencies of other industrial countries, weighted according to world-trade shares. That index shows that the dollar depreciated 31% from its peak in the first quarter of 1985 through the third quarter of 1986, implying substantial effects on the trade deficit.

First Interstate's U.S. dollar index is based on the currencies of the twelve most important U.S. trade partners, weighted according to their share of U.S. trade, and it indicates substantially different results, as the graph illustrates. The FI dollar contains currencies for five developing countries, Mexico, Brazil, Taiwan, South Korea, and Hong Kong, and these currencies have generally depreciated against the dollar. Moreover, Canada is the most important U.S. trading partner, and its dollar has also depreciated against the U.S. dollar. As a result, the FI dollar has appreciated 16.5% from the first quarter of 1985 through the third quarter of 1986, helping explain why the trade deficit has continued to increase.

Debt Burden Remains High

(Ratio of debt to exports for 15 Baker Plan countries)



U.S. Current Account Balance

(Billions of U.S. dollars)

	1982	1983	1984	1985	1986e	1987f	1988f
Trade Balance	-36.4	-67.2	-114.1	-124.4	-143.4	-148.4	-138.4
Exports	211.2	201.7	219.9	214.4	222.4	235.7	253.4
Imports	-247.6	-268.9	-334.0	-338.9	-365.8	-384.1	-391.8
Service Balance	36.1	30.1	18.2	21.8	19.7	18.5	17.9
Service Exports	138.3	132.8	142.1	144.1	149.7	157.3	164.7
Service Imports	-102.2	-102.8	-123.9	-122.3	-130.0	-138.8	-146.8
Transfer Balance	-8.9	-9.5	-11.4	-15.0	-16.1	-16.9	-17.7
Official	-7.7	-8.5	-10.1	-11.2	-12.0	-12.5	-13.0
Private	-1.2	-1.0	-1.3	-3.8	-4.1	-4.4	-4.7
Current Account Balance	-9.2	-46.6	-107.4	-117.7	-139.8	-146.7	-138.1

During the forecast period, the two indexes are expected to move further apart. The sharp appreciation of the FI dollar, however, largely reflects the expected depreciation of the Mexican peso because of inflation in that country. If the peso and the Brazilian cruzado are held constant, the FI dollar depreciates, but less than we expect for the Fed's dollar, as shown by the data in the table.

We expect an appreciation of the dollar during the first quarter of 1987, reflecting stronger U.S. real economic growth during the last half of 1986 than in other industrial countries. After that, market attention to the magnitude of the U.S. trade, current-account, and budget deficits, and increasing inflation relative to most other industrial countries should exert downward pressure on the dollar through the end of 1988. Factors keeping the dollar from depreciating at a faster rate will be increasing interest rates and the

strength of the economy in comparison to elsewhere. In fact, increasing U.S. real economic growth through the first quarter of 1988 should keep the dollar from depreciating during the second half of 1987 and the first third of 1988. As real economic growth begins to decline, the dollar should again trend downward.

U.S. Current-Account Deficits to Remain Large

After 1985's record merchandise-trade deficit of \$124 billion, we expect new records in

Trade-Weighted U.S. Dollar

(Percent change, 4th quarter-to-4th quarter)

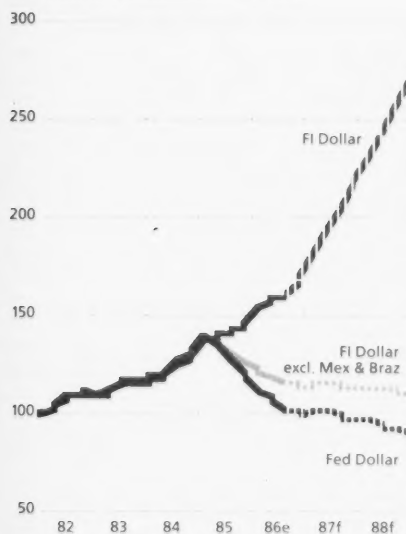
	1985	1986e	1987f	1988f
Fed	-12.9	-17.3	-2.8	-10.7
FI	11.1	16.3	29.8	24.5
FI excl. Mexico & Brazil	-3.2	-8.6	-0.8	-3.8

1986 and 1987. Only in 1988 will the deficit start to shrink, as the data in the table show. Two factors explain most of the increase in the trade deficit: (1) differential rates of real economic growth between the United States and its major trading partners and (2) the value of the U.S. dollar. Although U.S. real economic growth has slowed in 1986, the strong import growth (8%) reflects the fact that the dollar, on FI's trade-weighted basis, has not depreciated substantially.

In 1987, the effects of the depreciation of the dollar will be partially offset by the strong growth of the domestic economy. We expect U.S. exports to increase more rapidly than imports in 1987; nevertheless, the trade deficit should increase again. The reduction in the 1988 trade-deficit forecast reflects lower U.S. real economic growth and the further depreciation of the dollar. These factors should lead to stronger export growth and

Trade-Weighted Dollar Shows Varying Trends

(Quarterly indexes: 1982: 1 = 100)



lower import growth—but again, no absolute decline in imports.

Most of the goods currently imported will still be imported. Less expensive cars will be imported from South Korea and other countries, while Japan concentrates on more expensive cars. In addition, the production of consumer electronics will shift to the Asian NICs from Japan when quality can be assured; these goods will not be produced in the United States or Japan for the mass market. The improved competitiveness of the NICs in comparison to Japan is illustrated by the graph showing the depreciation of their currencies against the yen.

During the 1986-88 period, we expect the net-services surplus to decline, reflecting growing U.S. net indebtedness. We are forecasting a current-account deficit of more than \$135 billion annually, adding to U.S. net indebtedness. The United States will have little difficulty with its net-indebtedness position in the short run. Over the longer run, however, this situation will become increasingly vexatious to policymakers and to the country as a whole.

Capital Markets: Diversification and Deregulation

Activity in international capital markets is advancing rapidly. The gross volume of international borrowings increased 30% to \$257 billion during 1985. This year we expect it to approach \$325 billion. A major trend has been the phenomenal increase in securitized financing, now accounting for almost 85% of gross borrowings. In sharp contrast, syn-

dicated bank lending has declined significantly, accounting for only 12% of borrowings in 1986, compared with about 75% during the 1970s. The two most important developments in international capital markets during 1986 have been the fall in the U.S. dollar share of Eurobond financing and the deregulation of London's financial markets.

Dollar Share Declines in the Eurobond Market

Traditionally, the U.S. dollar dominated Eurobond offerings, accounting for up to 90% of the market. However, as the accompanying graph indicates, the dollar's importance has declined substantially during the 1980s. From 84% in 1982, the dollar's share fell to 71% in 1985 and is estimated to fall further to about 50% in 1986. This development has resulted partly from the sharp decline in the dollar against most major currencies and partly from the growing international importance of other currencies, particularly the yen. Moreover, the rise in the spread between Eurodollar interest rates and those in other currencies contributed to this development, as many borrowers raised funds in other currencies at lower rates and then swapped back into dollars, locking in below-market funding costs.

Countdown to Global Deregulation

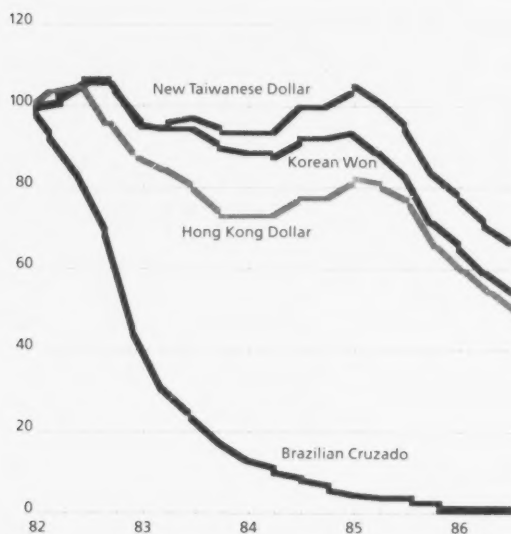
Financial-market deregulation, which started in 1984 and gained considerable momentum in 1985, came to a head in October with London's "Big Bang," or the integration of its

domestic and international financial markets. London, already the largest market for foreign-exchange trading (daily volume of \$90 billion, compared with \$50 billion in New York and \$48 billion in Tokyo), will become the center of the largest trading houses in the world. The salient features of the "Big Bang" are: (1) a system of negotiated commissions replaces fixed commissions on securities trading; (2) trading houses can now perform both broking and jobbing; (3) foreign banks are allowed to trade in both debt and equity securities; and (4) a new auction system replaces the Bank of England's system of gilt sales through a limited number of dealers. More limited liberalization has taken place in other financial-market centers. Growing international linkage of financial markets contains the risk that a financial crisis in one center could affect the global financial system.

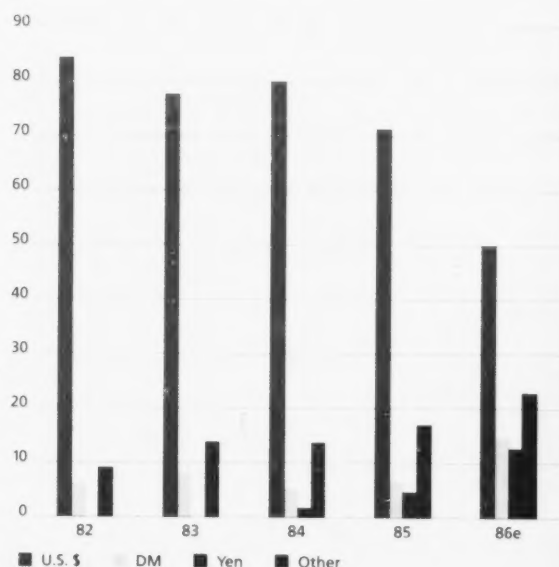
We expect the broad trends in international capital markets outlined above to continue during 1987-88. Investors will concentrate on prime-name borrowers as they emphasize creditworthiness. The rise in long-term interest rates included in our forecast should revive the floating-rate securities market. The market for back-up facilities will remain depressed, since the majority of high-quality borrowers now prefer to set up their own Euro-commercial paper programs. Further declines in the dollar and growing internationalization of the yen and other currencies imply that the dollar share of international financing will shrink further, but more slowly than in 1986.

NIC Currencies Fall Against Yen

(Index: 1st qtr. 1982 = 100)



Eurobonds: Decline in U.S. Dollar Share



First Interstate Bancorp

Affiliates:

Arizona

First Interstate Bank of Arizona, N.A.

California

First Interstate Bank of California
First Interstate Bank, Limited
First Interstate Bancard Co., N.A.

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First Interstate Bank of Denver, N.A.
First Interstate Bank of Englewood, N.A.
First Interstate Bank of Fort Collins, N.A.

Idaho

First Interstate Bank of Idaho, N.A.

Montana

First Interstate Bank of Glacier County
First Interstate Bank of Great Falls
First Interstate Bank of Kalispell, N.A.

Nevada

First Interstate Bank of Nevada, N.A.

New Mexico

First Interstate Bank of Albuquerque
First Interstate Bank of Lea County
First Interstate Bank of Roswell
First Interstate Bank of Santa Fe, N.A.

Oklahoma

First Interstate Bank of Oklahoma, N.A.

Oregon

First Interstate Bank of Oregon, N.A.

Utah

First Interstate Bank of Utah, N.A.

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